(15)

No. 90-1918-CSX
Status: GRANTED

Title: Kraft General Foods, Inc., Petitioner
v.
Iowa Department of Revenue and Finance

Docketed:
June 14, 1991

Court: Supreme Court of Iowa

Counsel for petitioner: Libin,Jerome B.

Counsel for respondent: Mason,Marcia

Entry	Date	Note	Proceedings and Orders
1	Jun 14 1991	G	Petition for writ of certiorari filed.
3	Jul 15 1991		Brief of respondent Iowa Department of Revenue and Finance in opposition filed.
6	Jul 15 1991		Brief amicus curiae of Committee on State Taxation filed.
2	Jul 17 1991		DISTRIBUTED. September 30, 1991
4	Jul 26 1991	X	Reply brief of petitioner Kraft General Foods, Inc. filed.
5	Jul 29 1991		9 copies of lodging received.
8	Oct 7 1991	P	The Solicitor General is invited to file a brief in this case expressing the views of the United States.
9	Dec 23 1991		Brief amicus curiae of United States filed.
10	Dec 31 1991		REDISTRIBUTED. January 17, 1992
11	Jan 2 1992	X	Supplemental brief of petitioner Kraft General Foods, Inc. filed.
12	Jan 21 1992		Petition GRANTED.
			**********
13	Jan 31 1992	G	Motion of petitioner to dispense with printing the joint appendix filed.
14	Feb 14 1992		Record filed.
		*	Certified copy of proceedings Supreme Court of Iowa
15	Feb 19 1992		Record filed.
		*	Original proceedings District Court for Polk County, Iowa.
16	Feb 24 1992		Motion of petitioner to dispense with printing the joint appendix GRANTED.
23	Mar 3 1992	G	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
17	Mar 4 1992		SET FOR ARGUMENT WEDNESDAY, APRIL 22, 1992. (2ND CASE).
19	Mar 6 1992		Brief of petitioner Kraft General Foods, Inc. filed.
20	Mar 6 1992		Brief amici curiae of Chevron Corporation, et al. filed.
21	Mar 6 1992		Brief amicus curiae of Washington Legal Foundation filed.
22	Mar 6 1992		Brief amici curiae of Avon Products, Inc., et al. filed.
			VIDED.
18	Mar 11 1992		CIRCULATED.
24	Mar 23 1992		Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED.
26	Apr 7 1992	X	Brief of respondent Iowa Department of Revenue and Finance filed.
25	Apr 8 1992	X	Brief amici curiae of National Conference of State Legislatures, et al. filed.
27	Apr 8 1992	X	Brief amicus curiae of United States filed.
28	Apr 15 1992	X	Reply brief of petitioner Kraft General Foods, Inc. filed.

2 pp

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Entry	Date	Note	Proceedings and Orders
29	Apr 22 1992		ARGUED.

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No. 90-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

KRAFT GENERAL FOODS, INC.
(formerly KRAFT, INC.),

Petitioner,

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF IOWA

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QUESTIONS PRESENTED

1. Whether a state statute can be found to discriminate impermissibly against foreign commerce in violation of the Foreign Commerce Clause without a showing that the discrimination provides a commercial advantage to purely local business.

2. Whether the Iowa Business Tax on Corporations, which facially discriminates against foreign commerce by including foreign subsidiary dividends in the Iowa corporate tax base while excluding domestic subsidiary dividends from that base, violates the Foreign Commerce Clause.

3. Whether the Iowa Business Tax on Corporations violates the Equal Protection Clause because its classification of dividend income is not rationally related to a legitimate state purpose.

Rule 29.1 Statement

The parent company of petitioner is Philip Morris Companies Inc. The subsidiaries of petitioner, other than wholly-owned subsidiaries, are listed in the Appendix at pages 76a-79a.

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KRAFT GENERAL FOODS, INC.
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IOWA DEPARTMENT OF REVENUE AND FINANCE,

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PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF IOWA

OPINIONS BELOW

The opinion of the Supreme Court of Iowa in this case has been reported at 465 N.W.2d 664 (Iowa 1991). The court's opinion is reproduced in the Appendix at pages 1a-10a. The order of the Supreme Court of Iowa denying rehearing is reproduced in the Appendix at page 57a. The findings of fact, conclusions of law, and judgment of the District Court of Iowa in and for Polk County have not been reported. They are reproduced in the Appendix at pages 11a-23a. The order of the Iowa Department of Revenue and Finance has not been reported. It is reproduced in the Appendix at pages 24a-27a.

JURISDICTION

The judgment of the Supreme Court of Iowa was entered on February 20, 1991. Petitioner's timely petition for rehearing was denied on March 19, 1991. (App. 57a). The jurisdiction of this Court is invoked under 28 U.S.C. sec. 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, art. I, sec. 8, cl. 3 provides: The Congress shall have power "[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

The Equal Protection Clause of the United States Constitution, amend. XIV, sec. 1 provides that: "No state shall . . . deny to any person within its jurisdiction the equal protection of the laws."

Relevant portions of Sections 422.33 and 422.35 of the Iowa Code, Sections 243, 901, 902, 1504, and 7701 of the Internal Revenue Code, and section 1.1502-14(a)(1) of the Federal Income Tax Regulations are set forth in the Appendix at pages 58a-65a, 66a-71a, and 72a, respectively.

STATEMENT

A. Relevant Facts

Petitioner is a Delaware corporation with its commercial domicile in Illinois. It operates a unitary business in Iowa, other states, and certain foreign countries. In 1981, petitioner owned more than 80 percent of the capital stock of six corporations that

were part of its unitary business and that conducted their business activities exclusively outside the United States. (App. 29a). Those subsidiaries (and their respective countries of incorporation) were Dominion Dairies Ltd. (Canada); Kraft Limited (Canada); Kraft Foods S/A (Denmark); Kraft G.m.b.H. (Germany); Kraft S.p.A. (Italy); and Alimentos Kraft de Venezuela C.A. (Venezuela). During 1981, those subsidiaries paid to petitioner aggregate dividends of $10,181,815, less foreign withholding taxes of $1,490,887, out of the profits from their foreign operations. (App. 53a).

For a variety of reasons, U.S. corporations conducting business abroad typically do so through subsidiary corporations organized in the countries in which they operate. The parties have stipulated that those reasons include, but are not limited to, the requirements of the foreign country, a better ability to limit the company's liability in that country, marketing advantages as customers perceive the subsidiary as a local company, greater ease in repatriating funds, greater ease in borrowing funds in the country of operation, and the ability to own property and to manufacture in that country. (App. 30a-31a).

B. Iowa Taxing Scheme

The Iowa Business Tax on Corporations imposes an income tax on that portion of the "net income" of a corporation attributable to its trade or business carried on within Iowa. The amount subject to tax is determined by the application of Iowa's apportionment formula to the corporation's entire unitary "net income." Iowa Code Ann. sec. 422.33 (West 1990 & Supp. 1991). Iowa law uses federal law as its starting point. It defines "net income" as "the taxable income

. . . as properly computed for federal income tax purposes under the Internal Revenue Code . . .", with certain adjustments. Iowa Code Ann. sec. 422.35 (West 1990 & Supp. 1991).[1]

1. Calculation of Federal "Taxable Income"

In determining "taxable income" for federal income tax purposes, the Internal Revenue Code permits a corporation to deduct from its gross income a certain percentage of the dividends it receives from "a domestic corporation which is subject to [federal income] taxation." 26 U.S.C. sec. 243.[2] For this purpose, a "domestic corporation" is defined as a corporation organized in the United States. 26 U.S.C. sec. 7701(a)(4).

If the dividend payor and recipient are members of the same "affiliated group" of corporations, *e.g.*, if the recipient owns at least 80 percent of the capital stock of the payor, a so-called "dividends received deduction" equal to 100 percent of the dividends received is allowed. 26 U.S.C. secs. 243, 1504.[3] Divi-

[1] For the taxable year 1981, the year here in question, the relevant Iowa Code provisions were essentially the same. Iowa Code secs. 422.33, 422.35 (1983).

[2] So far as here pertinent, the same basic provisions appear in both the Internal Revenue Code of 1954 and the Internal Revenue Code of 1986, as amended, and now in force. The term "Internal Revenue Code" as used throughout applies to either Code interchangeably.

[3] If the recipient corporation owns less than 80 percent of the capital stock of the payor corporation, the amount of the dividends received deduction is reduced. In 1981, the deduction in such a case equalled 85 percent of the dividends received. 26 U.S.C. sec. 243. (1976 & Supp. V 1981).

Members of an "affiliated group" of corporations (*i.e.*, those

dends eligible for the full 100 percent "dividends received deduction" are hereinafter referred to as "domestic subsidiary dividends."

In contrast to its treatment of "domestic subsidiary dividends," the Internal Revenue Code does not permit a corporation to deduct any portion of the dividends it receives from foreign subsidiaries that conduct their business operations exclusively in foreign countries. Such dividends are thus fully includible in U.S. taxable income. However, a credit is generally allowed to the recipient of dividends from foreign subsidiaries for related foreign taxes paid. 26 U.S.C. secs. 901, 902. Dividends received from a foreign subsidiary that conducts its business outside the United States, and in which the U.S. parent owns at least 80 percent of the capital stock, will hereinafter be referred to as "foreign subsidiary dividends."

Federal law does not tax domestic subsidiary dividends because they are drawn from income that itself is subject to U.S. tax as earned by the domestic subsidiary. The dividends received deduction thus avoids U.S. double taxation of the same income. Federal law taxes foreign subsidiary dividends because the underlying income earned by the foreign subsidiary is not subject to U.S. tax. The foreign tax credit is allowed to mitigate the consequences of international double taxation. Bittker and Eustice, *Federal Income Taxa-*

linked by at least 80 percent stock ownership) may elect to file a single consolidated federal income tax return. In such a case, dividends paid by a subsidiary to its parent corporation are also fully excluded from taxable income. (Treas. Reg. sec. 1.1502-14(a)(1).) Only domestic corporations are eligible to join in the filing of a consolidated return. (26 U.S.C. sec. 1504(b).)

tion of Corporations and Shareholders, ¶¶ 5.05 and 17.11 (5th ed. 1987).

2. Calculation of Iowa "Net Income"

As noted, Iowa adopts federal "taxable income" as the starting point for determining corporate "net income" that it subjects to apportionment. Accordingly, a corporation doing business in Iowa calculates its Iowa tax base with (1) "domestic subsidiary dividends" fully excluded, by virtue of the federal dividends received deduction, and (2) "foreign subsidiary dividends" fully included, by virtue of the absence of a comparable federal deduction for such dividends. Because Iowa does not adopt all provisions of the Internal Revenue Code, however, the corporation is not allowed a credit against its Iowa tax for related foreign taxes paid with respect to its foreign subsidiary dividends.

As illustrated by Exhibits 4 and 5 to the Stipulation below (App. 55a-56a), Iowa subjects a corporation receiving a $100,000 foreign subsidiary dividend to a greater tax than an otherwise similarly situated corporation receiving a $100,000 domestic subsidiary dividend. Iowa's inclusion of only foreign subsidiary dividends in the corporate tax base thus results in the imposition of a discriminatory income tax on any corporation operating in Iowa whose unitary business includes the activities of subsidiaries organized and operating in foreign countries.

C. Similar State Taxing Schemes

In addition to Iowa, 39 states utilize federal taxable income as the starting point for calculating net income subject to corporate income tax.[4] Nine of those states have adopted the federal tax treatment of foreign and domestic subsidiary dividends.[5] Two of the nine states discriminate in identical fashion with Iowa,[6] and seven do so with certain modifications.[7] Two other jurisdictions that do not follow the federal system discriminate in a manner similar to Iowa.[8]

D. Proceedings Below

In calculating its federal taxable income for 1981, petitioner included its foreign subsidiary dividends in

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[4] Five states with a corporate income tax (Alabama, Arkansas, California, Mississippi, and Utah) plus the District of Columbia do not utilize federal taxable income as the starting point in their calculations. Five other states (Nevada, South Dakota, Texas, Washington, and Wyoming) do not impose a corporate income tax.

See Appendix J for all state statutory citations.

[5] Fifteen of the 39 states have excluded both domestic and foreign subsidiary dividends from their tax base calculation. Arizona, Connecticut, Delaware, Florida, Georgia, Illinois, Indiana, Kentucky, Maryland, Michigan, Nebraska, Ohio, Pennsylvania, Virginia, and West Virginia.

Eleven states have included both in the calculation. Hawaii, Louisiana, Massachusetts, Minnesota, New Jersey, New York, North Carolina, North Dakota, Oregon, Tennessee, and Wisconsin.

Four states (Alaska, Idaho, Montana, and New Hampshire) that utilize federal taxable income have adopted variations on the federal law that make comparisons inappropriate.

[6] New Mexico and Vermont.

[7] Colorado, Kansas, Maine, Missouri, Oklahoma, Rhode Island, and South Carolina. For example, Kansas follows federal law by excluding 100 percent of domestic subsidiary dividends, but it includes 20 percent of foreign subsidiary dividends.

[8] Alabama and the District of Columbia.

accordance with applicable federal rules. (App. 32a). (Petitioner received no domestic subsidiary dividends in that year.) Petitioner also claimed a credit against its federal tax for foreign taxes paid with respect to its foreign subsidiary dividends. *Id.*

In calculating its 1981 "net income" for purposes of the Iowa Business Tax on Corporations, petitioner deducted its foreign subsidiary dividends from the amount of federal taxable income it had separately calculated. The Iowa Department of Revenue and Finance ("the Department") assessed additional tax against petitioner on the ground that the foreign subsidiary dividends should have been included in petitioner's Iowa tax base.

Before the Department, petitioner challenged the constitutionality of the Iowa taxing statute under the Commerce and the Equal Protection Clauses of the United States Constitution and on other grounds. The Iowa Director of Revenue declined to render a decision on the "facial constitutionality" of the statute. (App. 26a).

On review, the District Court of Iowa in and for Polk County ("District Court") held that the statute did not discriminate in violation of the Commerce Clause because it did not benefit "local in-state industry in detriment to out-of-state industry." (App. 16a-17a). The District Court also held that the tax did not result in multiple taxation in violation of the Commerce Clause, and that the statute did not violate the Equal Protection Clause.

The Supreme Court of Iowa affirmed. It held that the statute did not violate the Commerce Clause because it did not benefit Iowa businesses at the expense of foreign businesses (App. 7a-8a), and that the Equal Protection Clause was not violated because the State's purpose in using federal taxable income as the starting point for computing its tax base—taxpayer and administrative convenience—was a legitimate state purpose. (App. 23a).

The parties have stipulated that the total amount of tax assessed against petitioner by Iowa for 1981 was approximately $39,000 (App. 33a), approximately $17,000 of which was attributable to the issue here presented. The outcome of this case will affect taxable years of petitioner from 1978 forward. (App. 43a).

REASONS FOR GRANTING THE WRIT

The instant case squarely presents one of the most fundamental constitutional issues arising under the Foreign Commerce Clause—whether a state statute can be found to discriminate impermissibly against foreign commerce without a showing that the discrimination provides a commercial advantage to purely local business. Stated another way, the fundamental question to be resolved is whether a state taxing scheme that facially discriminates against foreign commerce must be shown to favor *intrastate commerce*, rather than *domestic commerce* generally, in order to be held unconstitutional.

The Iowa courts concluded that a showing of discrimination in favor of *intrastate commerce* was required before a state tax on foreign commerce could be considered unconstitutional under the Foreign Commerce Clause. The court below, although acknowledging that "Supreme Court decisions are unclear whether such a local bias must be found when discrimination against foreign commerce is alleged"

(App. 7a), based its holding entirely on a reading of this Court's decisions involving discrimination against *interstate commerce*. At no time has this Court ever suggested, let alone held, that a discriminatory state tax imposed on *foreign commerce* must be shown to produce a commercial advantage to purely local business before it can be declared invalid. Indeed, prior decisions of this Court strongly suggest a contrary conclusion.

The fundamental constitutional issue here presented is raised in the context of a question of considerable importance that this Court has yet to resolve—whether the Foreign Commerce Clause permits a state to discriminate by including foreign subsidiary dividends in its corporate tax base while excluding domestic subsidiary dividends from that base. Resolution of this question will affect all U.S. multinational corporations that conduct their unitary businesses both in Iowa (or any of the other jurisdictions with discriminatory taxing schemes) and in foreign countries, and that depend on foreign subsidiary dividends as an important source of capital. Discriminatory state taxation of such dividends inevitably places such corporations at a commercial disadvantage relative to those of their competitors whose unitary businesses rely on dividends from domestic subsidiaries.

There is clear disagreement and confusion at the state level regarding the proper test to be applied in determining impermissible discrimination under the Foreign Commerce Clause. Given the substantial number of states that continue to discriminate against foreign subsidiary dividends, guidance from this Court as to the meaning of the "nondiscrimination" requirement under the Foreign Commerce Clause is not only warranted, but absolutely necessary.

This Court should also review the instant case to establish that the disparate treatment of subsidiary dividends adopted by the Iowa legislature is not rationally related to a legitimate state purpose. Extensive reliance on federal tax definitions that do not further any substantive state tax policy can easily give rise to arbitrary distinctions at the state level. The classification of dividend income adopted by Iowa (and the other jurisdictions with similar taxing schemes) is one such example. This Court should make it clear that a mere assertion of "taxpayer and administrative convenience" is not sufficient to validate an arbitrary tax classification under the Equal Protection Clause.

I. IMPERMISSIBLE DISCRIMINATION AGAINST FOREIGN COMMERCE DOES NOT REQUIRE A SHOWING OF LOCAL BENEFIT.

A. The Decision Below Is in Conflict with Decisions of This Court and with Decisions of the Highest Courts of Two Other States.

In *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979), this Court stated that the determination whether a particular tax imposes an impermissible burden on "foreign commerce" is to be made in part by reference to the four tests enumerated in *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274 (1977). Those four tests, which were originally said to be applicable to determinations involving "interstate commerce," are substantial nexus, fair appor-

tionment, nondiscrimination, and a fair relationship to the services provided by the taxing State.[9]

The instant case focuses on the meaning of the "nondiscrimination" requirement as applied under the Foreign Commerce Clause.[10] The Iowa Supreme Court concluded that under existing precedent such as *Bacchus Imports, Ltd.* v. *Dias*, 468 U.S. 263 (1984), which involved discrimination against "interstate commerce," a party claiming that a state taxing scheme impermissibly discriminates in violation of the Commerce Clause is required to show that the alleged discrimination produces a commercial advantage to local business. As the court below stated:

> In the commerce-clause challenge here, we hold that Kraft must show, *as in the case of alleged interstate discrimination*, that Iowa businesses received a commercial advantage over foreign commerce due to Iowa's taxing scheme.

(App. 7a) (emphasis supplied). As will be shown, the Iowa court's analysis is fundamentally unsound.

[9] *Japan Line* went on to declare that because of the "more extensive constitutional inquiry" called for in cases involving the Foreign Commerce Clause, two additional considerations were also to be taken into account—the enhanced risk of multiple taxation, and the possible need for federal uniformity of treatment. *Japan Line*, 441 U.S. at 446-451.

[10] Although the instant case involves discrimination in the composition of the tax base, rather than discriminatory taxation *per se*, that distinction cannot be constitutionally significant. A state discriminates against foreign commerce whether it taxes such commerce at a higher rate than domestic commerce or includes in its tax base certain types of income when generated in foreign commerce but not when generated in domestic commerce. *Cf. Westinghouse Elec. Corp.* v. *Tully*, 466 U.S. 388, 404-405 (1984).

Nothing in *Shell Oil Co.* v. *Iowa Dept. of Revenue*, 488 U.S. 19 (1988), is inconsistent with this conclusion. *Shell* involved questions of extraterritoriality, not discrimination, in the composition of the Iowa tax base.

1. The Decision Below Conflicts with Prior Decisions of This Court and the Highest Court of Florida.

No decision of this Court has ever held that a finding of local commercial advantage is required in order to invalidate a discriminatory tax burden imposed on foreign commerce. The court below either disregarded or misinterpreted those prior decisions of this Court that involved facially discriminatory statutes aimed specifically at foreign commerce, and chose instead to rely on cases involving discrimination against interstate commerce.

This Court established over a century ago that the Framers did not intend to permit a state to single out foreign commercial activity for taxation with virtual impunity, provided only that the state not benefit purely local interests. In *Cook* v. *Commonwealth of Pennsylvania*, 97 U.S. 566 (1878), a decision the court below refused even to acknowledge, this Court struck down as violative of the Foreign Commerce Clause a Pennsylvania tax that was imposed on foreign goods sold at auction, but that specifically exempted "groceries, goods, wares and merchandise of American growth or manufacture." *Id.* at 569. No showing of a local benefit or advantage inuring to items produced in Pennsylvania was required to establish the invalidity of the tax.

Similarly, in *Hale* v. *Bimco Trading, Inc.*, 306 U.S. 375 (1939), this Court considered the validity of a Florida statute that required the inspection of, and

the payment of an inspection fee with respect to, cement imported into Florida from any foreign country. While the legislative history of the statute suggested a desire to benefit the Florida cement industry, the statute imposed no inspection requirements on cement delivered into Florida from other parts of the United States. It thus benefitted all domestic cement producers to the detriment of foreign producers. This Court held that the statute impermissibly discriminated against foreign commerce.

Finally, in discussing concerns of multiple taxation under the Foreign Commerce Clause, this Court in *Japan Line* declared that a state tax "may subject foreign commerce 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.' " *Japan Line*, 441 U.S. at 448 (brackets in original), quoting from *Evco* v. *Jones*, 409 U.S. 91, 94 (1972), which in turn quoted from *J.D. Adams Mfg. Co.* v. *Storen*, 304 U.S. 307, 331 (1938), both of which involved "interstate commerce" issues.

By replacing the original word "intrastate," as used in *J.D. Adams Mfg. Co.*, with the bracketed word "[domestic]," this Court in *Japan Line* indicated rather clearly that the Foreign Commerce Clause compares the effect of a statute on foreign commerce with its effect on domestic commerce generally, not with its effect solely on intrastate or purely local commerce. The decision below is totally inconsistent with that position.

The Iowa Supreme Court's decision is also in direct conflict with the holding of the Florida Supreme Court in *Miller* v. *Publicker Industries, Inc.* 457 So. 2d 1374 (Fla. 1984). That case, which like *Cook* v. *Pennsylvania*, *supra*, was completely ignored below, involved the validity of a Florida fuel tax exemption granted only to gasohol containing ethyl alcohol "distilled from U.S. agricultural products or byproducts." The Florida Supreme Court held that the tax exemption violated the Foreign Commerce Clause because it facially discriminated against foreign commerce in ethyl alcohol. No showing was made or required that the tax favored only ethyl alcohol produced in Florida. It was enough that the tax discriminated against foreign produced ethyl alcohol to the benefit of domestically produced ethyl alcohol.

Here, by contrast, the court below refused to strike down the Iowa taxing scheme as applied to foreign subsidiary dividends, even though that scheme clearly favors corporations that conduct their unitary business operations through domestic subsidiaries. The repatriation of foreign subsidiary dividends into the U.S. is as much a part of foreign commerce as is the importation of ethyl alcohol produced abroad. (See *Mobil Oil Corp.* v. *Commissioner of Taxation*, 445 U.S. 425, 446-449 (1980).) Subjecting either item to tax while exempting its domestic counterpart must be equally unconstitutional under the Foreign Commerce Clause.

2. The Analysis of the Court Below Also Squarely Conflicts with the Interpretation of This Court's Prior Decisions by the Highest Court of California.

A second reason why the conclusion of the Iowa Supreme Court is erroneous is that a finding of local commercial advantage is not in fact the *sine qua non* for every determination of impermissible discrimination, even against "interstate commerce." In *Boston Stock Exchange* v. *State Tax Comm'n*, 429 U.S. 318,

335 (1977), this Court declared that a state tax that "discriminates between two types of interstate transactions in order to favor local commercial interests over out-of-state businesses" violates the Commerce Clause. *Boston Stock Exchange* struck down a New York tax on stock transfers that discriminated against sales made by residents and nonresidents outside New York in favor of sales made by nonresidents in New York. While New York's local stock transfer agents, who registered changes in stock ownership, were expected to benefit from an increase in sales made on the New York Stock Exchange, the tax by its terms did not directly advantage that local activity.

In contrast to the approach of the court below, the Supreme Court of California relied on *Boston Stock Exchange* to conclude that the Commerce Clause prohibits "discriminatory tax burdens which favor one class of commerce, subject to the control of Congress, over another such class . . . ." *Zee Toys, Inc.* v. *County of Los Angeles*, 85 Cal. App. 3d 763, 775, 149 Cal. Rptr. 750, 758 (1978), *aff'd by an equally divided Court, sub nom. Sears, Roebuck and Co.* v. *County of Los Angeles*, 449 U.S. 1119 (1981).

In *Zee Toys*, the California court held that a state ad valorem tax that discriminated against interstate commerce *in favor of foreign commerce* violated the Commerce Clause. That holding was reaffirmed in *Star-Kist Foods, Inc.* v. *County of Los Angeles*, 227 Cal. Rptr. 391, 42 Cal. 3d 1, 719 P.2d 987 (1986), *cert. denied*, 480 U.S. 930 (1987). In California, therefore, discrimination in favor of local business is *not* essential to the invalidation of a state statute under the Interstate Commerce Clause. The reasoning of the

court below squarely conflicts with the position of the California Supreme Court on this point.

B. The Issue Here Presented Is One of Great Significance to U.S. Multinational Corporations That Carry on Their Unitary Businesses Partly Through Foreign Subsidiaries.

Iowa is one of three states specifically requiring that the calculation of its corporate tax base be made in strict accordance with federal law insofar as the treatment of subsidiary dividends is concerned. Another nine jurisdictions discriminate against foreign subsidiary dividends in a similar manner.[11]

The issue here presented thus extends far beyond the boundaries of the State of Iowa. Resolution of this issue will affect a substantial number of U.S. corporations that conduct their business operations partly through foreign subsidiaries and that compete in states such as Iowa with corporations that rely on dividends received from domestic subsidiaries.

While this Court previously considered the question of state taxing power over foreign subsidiary dividends in *Mobil*, *supra*, it did not address the precise issue here presented. The issues in *Mobil* were whether Vermont's tax on dividends paid by both domestic and foreign subsidiaries engaged in overseas operations violated the Due Process Clause (lack of substantial nexus) or the Commerce Clause (burden on interstate commerce by virtue of the fact that tax could also be imposed by state of commercial domicile; burden on foreign commerce by virtue of risk of multiple taxation). Mobil specifically chose not to raise

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[11] See discussion at pages 6-7, *supra*.

the "discrimination" issue, even though the Vermont statute was essentially identical to the Iowa statute here involved.[12] There is thus nothing in the *Mobil* opinion that addresses the question raised by the instant case.[13]

The issue here presented is one of fundamental constitutional significance, and is of national importance. By misapplying basic constitutional principles, the court below placed itself in direct conflict with prior decisions of this Court and the highest courts of two other states. This Court should therefore grant the writ to reaffirm its prior holdings on the meaning of the Foreign Commerce Clause, and to establish the full scope of the "nondiscrimination" requirement as applied to the taxation of foreign commerce.

II. IOWA'S CLASSIFICATION OF DIVIDEND INCOME DENIES PETITIONER EQUAL PROTECTION BECAUSE IT IS NOT RATIONALLY RELATED TO A LEGITIMATE STATE PURPOSE.

This Court has not hesitated to invoke the Equal Protection Clause to reject attempts by a state to tax one class of taxpayers on a more onerous basis than another similarly situated class. *Williams* v. *Vermont*, 472 U.S. 14 (1985); *WHYY, Inc.* v. *Borough of Glassboro*, 393 U.S. 117 (1968); *Wheeling Steel Corp.* v. *Glander*, 337 U.S. 562 (1949). Iowa's discriminatory classification can only survive an equal protection challenge if it is "rationally related to achievement of a legitimate state purpose. . . ." *Western & Southern Life Ins. Co.* v. *State Bd. of Equalization*, 451 U.S. 648, 668 (1981).

A. In Contrast to the Federal Tax Treatment of Subsidiary Dividends, No Legitimate State Purpose Is Served by the Classification Adopted by Iowa.

As previously discussed, federal law does not tax domestic subsidiary dividends because it would result in U.S. double taxation of corporate income. Federal law taxes foreign subsidiary dividends because the underlying income of foreign subsidiaries is not itself subject to U.S. tax. (Federal law allows a foreign tax credit to mitigate international double taxation.)

As noted, Iowa adheres strictly to the federal tax treatment of dividend income for purposes of calculating its corporate tax base. However, action that is legitimate when taken at the federal level may become illegitimate when undertaken by a state. *Compare Matthews* v. *Diaz*, 426 U.S. 67 (1976) (alienage distinction in *federal* Medicare law does not violate equal protection) *with Graham* v. *Richardson*, 403 U.S. 365 (1971) (alien exclusion in *state* welfare law violates equal protection).

Iowa cannot avail itself of the federal government's legitimate purpose for excluding domestic subsidiary dividends while taxing foreign subsidiary dividends. Iowa excludes domestic subsidiary dividends even where the income from which they are drawn is not subject to Iowa tax, and offers no credit for foreign taxes paid with respect to foreign subsidiary dividends. Iowa's focus is thus not on double taxation at

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[12] Mobil's decision not to raise the discrimination issue was apparently part of its overall "litigation strategy." (See 445 U.S. at 434).

[13] Two other cases dealing with the taxation of foreign dividends, *ASARCO, Inc.*, v. *Idaho State Tax Comm'n*, 458 U.S. 307 (1982), and *F.W. Woolworth Co.* v. *Taxation and Revenue Dept.*, 458 U.S. 354 (1982), addressed only the Due Process question whether the dividend-paying foreign subsidiaries there involved were part of the unitary businesses of the taxpayers.

all, and its distinction between classes of dividends is completely lacking in substantive tax policy justification.

In recognition of this fact, the Iowa Supreme Court enumerated five purposes purportedly served by the State's differentiation in the treatment of subsidiary dividends. According to the court:

> [T]he coupling of Iowa net income with the federal formula is convenient for the taxpayer, prevents the taxpayer from spending time and money on complex forms, provides a saving to the state, allows the state to rely on federal regulation and interpretation, and provides the state with an inexpensive and quick way of verifying the accuracy of taxpayers returns.

(App. 10a).

"Taxpayer and administrative convenience" cannot be the measure of constitutionality, however, because a state can always claim convenience to justify the imposition of unequal burdens on similarly situated taxpayers. *Cf. Allegheny Pittsburgh Coal Co.* v. *County Comm'n*, 488 U.S. 336, 343 (1988) (equal protection violation found where tax assessments for comparable property were dramatically different because assessor claimed accurate property valuations were only readily available for recently purchased property).

For example, it may be convenient for Iowa to tax Illinois corporations doing business in Iowa based solely on their net income as calculated for Illinois tax purposes: such corporations would not have to spend time and money filling out multiple forms, and the two states could reduce the cost of administering

their tax systems and verifying the accuracy of tax returns by combining their audit efforts. But surely such separate treatment of Illinois corporations vis-a-vis all other corporations doing business in Iowa would not be deemed to satisfy equal protection requirements merely because of the taxpayer and administrative convenience it would afford.[14]

In short, Iowa has no legitimate purpose for taxing corporations receiving foreign subsidiary dividends more onerously than those receiving domestic subsidiary dividends.

B. Iowa's Taxing Scheme Is Inconsistent with the Contention That Its Discrimination Is Rationally Related to Achieving Taxpayer or Administrative Convenience.

Even if the goal of taxpayer and administrative convenience were a legitimate one in this context, Iowa's extensive modifications to the definition of federal taxable income in determining "net income" subject to apportionment undermine its claim that reliance on the federal calculation is in fact "convenient."

For the year 1981, Iowa's taxing statute required corporate taxpayers to make nine separate adjust-

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[14] Iowa itself has recognized that administrative convenience *per se* cannot override other constitutional limitations. In calculating "net income" for Iowa purposes, Iowa taxpayers are required to adjust their federal taxable income by, among other adjustments, subtracting out interest and dividends from federal securities. Iowa Code sec. §422.35 (1983). Iowa thus observes the doctrine of intergovernmental immunity, founded upon the "Borrowing" and "Supremacy" clauses, *Weston* v. *Charleston*, 2 Pet 449, 7 L.Ed. 481 (1829); *Society For Savings* v. *Bowers*, 349 U.S. 143, 144 (1954), and codified by Congress, 31 U.S.C. sec. 3124 (1988), which limits a state's power to tax income from federal securities.

ments to their federal taxable income in order to determine their proper Iowa tax base. Those adjustments consisted of the following: (1) subtract interest and dividends from federal securities; (2) add other interest and dividends exempt from federal tax; (3) adjust the basis used on the federal return for determining gain or loss on the sale of certain assets; (4) subtract 50 percent of net federal income taxes paid; (5) add certain amounts relating to depreciable assets shown on the federal return; (6) subtract targeted job credits granted on the federal return; (7) subtract certain alcohol fuel credits allowed on the federal return; (8) add certain amounts deducted on the federal return for sale-leaseback agreements; and (9) add the windfall profits tax determined on the federal return. Iowa Code sec. 422.35. (1983). (Iowa now requires thirteen adjustments to federal taxable income. Iowa Code Ann. sec. 422.35 (West 1990 & Supp. 1991).)

The varied and complex adjustments required by Iowa undoubtedly cause taxpayers to spend additional time and money in tax preparation. They also undoubtedly require the state to incur particular costs in the administration of its system to verify the adjustments made. It is thus highly doubtful that Iowa's reliance on federal taxable income as the starting point for its tax base calculations serves the purposes articulated by the court below. Reliance on federal taxable income cannot fairly be said to rationally support the goal of taxpayer and administrative convenience if a multiplicity of separate calculations are also required by the state.

Yet, unless this Court reviews the instant case, states like Iowa will continue to believe that, however

arbitrary their tax classifications may be, a mere assertion of "taxpayer and administrative convenience" is all that is required to satisfy the standards of the Equal Protection Clause.

CONCLUSION

For all of the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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June 14, 1991

APPENDIX

APPENDIX A

IN THE SUPREME COURT OF IOWA

No. 294/89-1528

Filed February 20, 1991

KRAFT, INC.,

Appellant,

vs.

IOWA DEPARTMENT OF REVENUE AND FINANCE,

Appellee.

Appeal from the Iowa District Court for Polk County, Theodore H. Miller, Judge.

Corporation appeals from judicial review of agency decision subjecting dividends received from foreign subsidiaries to Iowa income tax. AFFIRMED.

John V. Donnelly and Harold N. Schneebeck of Brown, Winick, Graves, Donnelly, Baskerville & Schoenebaum, Des Moines, for appellant.

Thomas J. Miller, Attorney General, Harry M. Griger, Special Assistant Attorney General, and Marcia Mason, Assistant Attorney General, for appellee.

Considered by McGiverin, C.J., and Larson, Schultz, Snell, and Andreasen, JJ.

LARSON, J.

Kraft, Inc., a corporation subject to Iowa income tax, receives dividends from subsidiaries in foreign countries. Under Iowa's income tax statutes, these dividends are required to be included in Kraft's net income, even though dividends from domestic subsidiaries are not. Kraft complains that this violates the commerce clause of the United

States Constitution and denies it equal protection under both the United States and Iowa Constitutions. The district court rejected these arguments, and so do we.

In 1981, the year in question, Kraft received substantial dividends from these subsidiaries from which the foreign countries had withheld their respective taxes. Also, the foreign subsidiaries themselves were taxed by the foreign countries on the earnings from which the dividends had been paid.

Sections 241 and 243 of the Internal Revenue Code, 26 U.S.C., allow taxpayer to deduct from its net income all dividends received from *domestic* subsidiaries. The reason is said to be that all of the domestic corporations' earnings have already been subjected to federal income tax. *United States v. Georgia R.R. & Banking Co.*, 348 F.2d 278, 283 (5th Cir. 1965), *cert. denied*, 382 U.S. 973 (1966). Through Iowa Code section 422.35, which adopts the federal definition of net income, the dividends from a domestic subsidiary are likewise excluded from the Iowa income tax base. Dividends received from *foreign* subsidiaries, however, may not be deducted for federal income tax purposes, although the taxpayer is allowed to claim a *credit* against its federal income tax for the foreign taxes paid.

Iowa does not allow a credit for taxes paid to foreign countries, and therein lies the problem in this case: By adopting the federal formula for computing net income, Iowa allows a deduction for dividends received from domestic corporations, but it does not allow a deduction or tax credit for those received from foreign subsidiaries. Kraft contends that this is unlawful discrimination.

Iowa income tax is imposed upon the portion of a taxpayer's "net income" attributable to its trade or business within Iowa. Iowa Code § 422.33.[1] Section 422.35 defines "net income" as "the taxable income before the net operating loss deduction, as properly computed for federal income tax purposes under the Internal Revenue Code of 1954 . . . .[2]

[1] Unless otherwise specified, all references will be to the 1981 Code.

Under the Iowa taxing system, businesses with multistate or multinational operations pay Iowa income tax on an apportioned basis. Under this method, the business divides its net income between Iowa and the other states or nations in which it does business. The taxpayer multiplies its total net income by a fraction, the numerator of which is the amount of Iowa-based income and the denominator of which is the total income earned by the taxpayer. Iowa Code §§ 422.33(1)(b); 701 Iowa Admin. Code 54.2. The resulting figure is the measure of the tax to be imposed as a result of the taxpayer's Iowa activities. *See Kelly-Springfield Tire Co. v. Iowa State Bd. of Tax Review*, 414 N.W.2d 113, 119 (Iowa 1987).

Kraft argues that the effect of including the foreign dividends in the denominator of this fraction is to tax those dividends; however, this is not actually correct. As the Supreme Court has noted,

> income that is included in the preapportionment tax base is not, by virtue of that inclusion, taxed by the State. Only the fraction of total income that the apportionment formula determines (by multiplying the income tax base by the apportionment fraction) to be attributable to Iowa's taxing jurisdiction is taxed by Iowa.

Shell Oil Co. v. Iowa Dep't of Revenue, 488 U.S. 19, 30, 109 S.Ct. 278, ___, 102 L. Ed. 2d 186, 199 (1988).

In its 1981 federal income tax return, Kraft included the foreign dividends in its tax base, as required, and claimed a foreign tax credit against its federal income tax. In com-

[2] Section 422.35 also allows certain adjustments, none of which are relevant to this case.

puting its Iowa tax base for 1981, however, Kraft deducted the foreign subsidiary dividends from its Iowa net income. It concedes this violates the Iowa tax statutes. The question is whether those statutes are constitutionally valid.

I. The Commerce Clause Argument.

The United States Constitution gives Congress the power "[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes . . . ." Art. I, § 8, clause 3. The commerce clause not only confers power on the federal government to regulate commerce but also limits state power to interfere with it. *Lewis v. BT Inv. Managers, Inc.*, 447 U.S. 27, 35, 100 S. Ct. 2009, 2015, 64 L. Ed. 2d 702, 711 (1980). This limitation on state power is often referred to as the "negative implication" of the commerce clause. *New Energy Co. v. Limbach*, 486 U.S. 269, 273, 108 S. Ct. 1803, ___, 100 L. Ed. 2d 302, 308 (1988); L. Tribe, *American Constitutional Law* § 6-2, at 403 (2d ed. 1988).

The Supreme Court has articulated a four-part test to determine whether a state tax violates the commerce clause. A tax is valid under a commerce clause challenge

> when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, *does not discriminate against interstate commerce*, and is fairly related to the services provided by the State.

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279, 97 S. Ct. 1076, ___, 51 L. Ed. 2d 326, 331 (1977) (emphasis added). When the challenged state tax affects commerce *outside* the United States, as here, "a more extensive constitutional inquiry is required." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 446, 99 S. Ct. 1813 ___, 60 L. Ed. 2d 336, 346 (1979). When foreign commerce is involved, two additional inquiries must be made:

> [F]irst, whether the tax . . . creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from "speaking with one voice when regulating commercial relations with foreign governments."

Id. at 451, 99 S. Ct. at ___, 60 L. Ed. 2d at 349. If a state tax contravenes either of these precepts, it is unconstitutional. *Id.* Kraft does not ask us to apply this test which is specifically applicable to foreign commerce; rather, it confines its argument to the third prong of *Complete Auto Transit*, claiming that Iowa's tax system unconstitutionally discriminates against foreign commerce.

State statutes are presumed to be constitutional. *Iowa Auto. Dealers v. State Appeal Bd.*, 420 N.W.2d 460, 462 (Iowa 1988). In addition, "[a]ll presumptions are in favor of the constitutionality of the statute and it will not be held invalid unless it is clear, plain and palpable that such decision is required." *City of Waterloo v. Selden*, 251 N.W.2d 506, 508 (Iowa 1977). *Accord Harden v. State*, 434 N.W.2d 881, 885 (Iowa), *cert. denied*, ___ U.S. ___ (1989). This presumption in favor of constitutionality is especially strong where the statute was enacted to promote a public purpose and relates to taxation. *Lee Enters., Inc. v. Iowa State Tax Comm'n*, 162 N.W.2d 730, 739 (Iowa 1968).

The department of revenue argues that the Iowa tax structure does not unconstitutionally discriminate because it does not advantage any local Iowa activity at the expense of non-Iowa activities. According to the department, unlawful discrimination does not exist under the commerce clause unless the statute provides a direct commercial advantage to local business. *See Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 268, 104 S. Ct. 3049, ___, 82 L. Ed. 2d 200, 207 (1984); P. Hartman, *Federal Limitations in State and Local Taxation* § ___, at 20 (Supp. 1985) ("A tax is generally said by the Court to be discriminatory

when the taxing State provides a commercial advantage to local business at the expense of out-of-state business.").

Kraft agrees that, in the interstate context, the cases could be read to support the department's argument that some advantage to local business must be shown. It argues, however, that the rules are different in the case of *foreign* commerce. Kraft relies in part on *Hale v. Bimco Trading, Inc.*, 306 U.S. 375, 59 S. Ct. 526, 83 L. Ed. 771 (1939). In *Hale*, the Supreme Court invalidated a Florida statute which provided for the inspection of all imported cement and the payment of a fee for such inspection. The inspection and fee applied to cement brought into Florida from a foreign country, but not to domestic cement. The statute's preamble provided two justifications for the inspection of foreign cement and its attendant fees: first, public safety required that the cement sold in Florida must meet minimum standards, and second, the imported cement created unfair competition to Florida's cement industry.

The Supreme Court pointed out the defects in the public safety rationale: "That no Florida cement needs any inspection while all foreign cement requires inspection at a cost of fifteen cents per hundredweight is too violent an assumption to justify the discrimination here disclosed." *Id.* at 380, 59 S. Ct. at ___, 83 L. Ed. at 776. It noted, as to the second justification, that it was "a candid admission that the very purpose of the statute is to keep out foreign goods." *Id.* Thus, in *Hale*, the Florida statute gave Florida's cement industry a distinct, and unconstitutional, advantage over foreign commerce.

Kraft also relies on *Japan Line, Ltd.* to support its discrimination argument. In *Japan Line, Ltd.*, California's *ad valorem* property tax on Japanese-owned shipping containers was held to violate the commerce clause because it resulted in possible multiple taxation, thereby preventing the United States from "speaking with one voice" in regulating foreign affairs. *Id.* at 452, 99 S.Ct. at ___, 60 L. Ed. 2d at 350. *Japan Line, Ltd.* did not involve discrimination against foreign commerce, which is the basis of Kraft's commerce clause argument.

Although Supreme Court decisions are unclear whether such a local bias must be found when discrimination against foreign commerce is alleged, the authors of one article have stated:

> Arguably, disparity between interstate and foreign commerce is not the evil that the commerce clause generally is supposed to prevent. The commerce clause may be viewed as a protection from local biases against either interstate or foreign commerce. Thus, it can be concluded that not only negative effects on protected commerce, but also positive effects on local commerce are necessary to find a statute unconstitutional under the commerce clause.

Tatarowicz & Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 Vand. L. Rev. 879, 941 (1986). In the commerce-clause challenge here, we hold that Kraft must show, as in the case of alleged interstate discrimination, that Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme.

Kraft alleges that local Iowa businesses are advantaged because taxpayers which receive dividends from domestic subsidiaries are benefited in the form of a lower Iowa income tax than if dividends from both foreign and domestic subsidiaries were taxed alike. We do not subscribe to this argument; this "benefit" is not created at the disadvantage of out-of-state businesses. Kraft is incorrect in comparing Iowa businesses to each other; the question is whether Iowa businesses are benefited at the expense of foreign businesses. Because the Iowa tax does not differentiate between in-state or out-of-state taxpayers, no im-

permissible discrimination exists. This case is therefore factually distinguishable from *Hale*.

II. The Equal Protection Argument.

Our court has recognized that Iowa Constitution, article 1, section 6 places substantially the same limitation on state legislation as does the equal protection clause of the fourteenth amendment. *See Hearst Corp. v. Iowa Dep't of Revenue & Fin.*, 461 N.W.2d 295, 304 (Iowa 1990); *Klein v. Department of Revenue & Fin.*, 451 N.W.2d 837, 842 (Iowa 1990); *Harden*, 434 N.W.2d at 885. Consequently, Kraft's challenges to the tax statutes under the United States and Iowa Constitutions will be addressed simultaneously.

A party challenging a statute under the equal protection clause has a heavy burden. *Bennett v. City of Redfield*, 446 N.W.2d 467, 474 (Iowa 1989); *Iowa S. Utils. Co. v. Iowa State Commerce Comm'n*, 372 N.W.2d 274, 279 (Iowa 1985); *Stracke v. City of Council Bluffs*, 341 N.W.2d 731, 734 (Iowa 1983). Kraft has

> the burden to demonstrate beyond a reasonable doubt the act violates the [equal protection clause] and to point out with particularity the details of the alleged invalidity. To sustain this burden [*Kraft*] *must negative every reasonable basis which may support the statute.* Every reasonable doubt is resolved in favor of constitutionality.

Selden, 251 N.W.2d at 508 (citations omitted) (emphasis added).

We have applied the Supreme Court's "standard of rationality" in evaluating state economic regulations. *Hearst Corp.*, 461 N.W. 2d at 304-06; *Bennett*, 446 N.W.2d at 474. In *Selden*, 251 N.W.2d at 509, we quoted *City of New Orleans v. Dukes*, 427 U.S. 297, 303-04, 96 S. Ct. 2513, ___, 49 L. Ed. 2d 511, 516-17 (1976):

> When local economic regulation is challenged solely as violating the Equal Protection Clause,

> this Court consistently defers to legislative determinations as to the desirability of particular statutory discriminations. Unless a classification trammels fundamental personal rights or is drawn upon inherently suspect distinctions such as race, religion, or alienage, our decisions presume the constitutionality of the statutory discriminations and *require only that the classification challenged be rationally related to a legitimate state interest* . . . . [I]n the local economic sphere, it is only the invidious discrimination, the wholly arbitrary act, which cannot stand consistently with the Fourteenth Amendment.

(Citations omitted) (emphasis added). Since no suspect classification or fundamental right is claimed in this case,[3] Iowa's taxing statute survives Kraft's equal protection challenge unless it is wholly arbitrary, having no rational relation to any legitimate state purpose. *See Hearst Corp.*, 461 N.W.2d at 305; *Klein*, 451 N.W.2d at 842; *Bennett*, 446 N.W.2d at 474; *Harden*, 434 N.W.2d at 885.

Dividends from foreign subsidiaries are taxed differently from those received from domestic subsidiaries, because Iowa bases "net income" on the taxable income figure reported on the federal income tax return. *See* Iowa Code § 422.33. As we said in *First National Bank of Ottumwa v. Bair*, 252 N.W.2d at 723, 726 (Iowa 1977):

> The result is practical. The taxpayer is permitted to merely lift the figures off the federal return and transfer them to the Iowa franchise tax return. The Department of Revenue receives the

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[3] Suspect classifications generally are based on race, alienage, or national origin. Fundamental rights include the right to vote, the right of interstate travel, and other rights, such as those guaranteed by the First Amendment, which are considered essential to individual liberty. *Bennett*, 446 N.W.2d at 473 (citations omitted).

benefit of the regulations and interpretations of the federal agency.

The coupling of Iowa net income with the federal formula is convenient for the taxpayer, prevents the taxpayer from spending time and money on complex forms, provides a saving to the state, allows the state to rely on federal regulation and interpretation, and provides the state with an inexpensive and quick way of verifying the accuracy of taxpayers' returns. We hold that the use of the federal net income figure for computing Iowa franchise tax "net income" is a legitimate purpose.

Kraft argues that Iowa's taxing scheme is not rationally related to achieving conformity with the federal system. This is because Iowa does not follow the internal revenue code in allowing a tax credit to corporations who pay foreign taxes on foreign dividends. However, complete conformity to the federal tax system is not the legitimate purpose claimed. The legitimate state purpose is to couple Iowa "net income" with federal taxable income, with the resulting advantages outlined above. It is a familiar principle that a "statute is not invalid under the Constitution because it might have gone farther than it did." *Katzenbach v. Morgan*, 384 U.S. 641, 657, 86 S. Ct. 1717, ___, 16 L. Ed. 2d 828, 839 (1966) (quoting *Roschen v. Ward*, 279 U.S. 337, 339, 49 S. Ct. 336, ___, 73 L. Ed. 722, 729 (1929)).

We hold that the income tax statutes in question, Iowa Code §§ 422.33, 422.35, are not invalid under the equal protection clauses of either the United States or Iowa Constitution.

We find no error in the district court ruling and therefore affirm.

AFFIRMED.

APPENDIX B

IN THE DISTRICT COURT OF IOWA
IN AND FOR POLK COUNTY

Case No. AA-1399

FINDINGS OF FACT,
CONCLUSIONS OF LAW,
AND JUDGMENT

KRAFT, INC.

Plaintiff,

vs.

IOWA DEPARTMENT OF REVENUE AND FINANCE,

Defendant.

This cause of action came on before this Court, the parties being represented by counsel. This is a judicial review of final agency action of the Iowa Department of Revenue and Finance instituted by Kraft, Inc. Jurisdiction is by and pursuant to the Iowa Code Chapter 17A.

"FINDINGS OF FACT"

There was a stipulation of the parties and exhibits thereto which is incorporated by reference. A contested case proceeding was before the Director of Revenue and Finance, J.D. Bair, August 16, 1988. On August 18, 1988, the Director of the Department issued a final order in which he concluded that he lacked authority to decide the issues contested which involved facial constitutionality of tax statutes. He further decided he had no authority to decide whether any decision on these issues should be applied prospectively only. The petition for review was then filed with this Court to review the Director's order. This Court finds it has jurisdiction pursuant to Section 17A, 19

the Iowa Code. The relevant facts are not in dispute and the Court proceeds under the stipulated facts.

Kraft, Inc. is a corporation duly organized and existing under the laws of the State of Deleware (sic), with its principle office and commercial domicile located in the State of Illinois, and qualified to do business in the State of Iowa. During 1981, Kraft owned capital stock representing more than 80% of the total voting power and total value of several corporations organized and conducting their respective business exclusively outside the United States, which corporations were not subject to United States income tax. These types of subsidiary corporations located in foreign countries are known as "foreign subsidiaries".

In 1981, Kraft's foreign subsidiaries declared and paid dividends to Kraft. The foreign countries in which these foreign subsidiaries were located required the subsidiaries to withhold income taxes imposed by the countries upon the declared dividends of Kraft and to remit such taxes. In addition, the foreign subsidiaries were taxed directly by the foreign countries upon their earnings, from which the dividends to Kraft were declared. Thus, the foreign countries, utilizing the "arms-length" approach to income taxation, taxed the earnings represented by the foreign dividends twice, once to the foreign subsidiaries and second to Kraft.

In 1981, the Internal Revenue Code, for federal income tax purposes, allowed a deduction in computing a domestic corporation's federal taxable income equal to 100% of non-qualifying dividends received from domestic subsidiaries. However, a domestic corporation such as Kraft, which received dividends from foreign subsidiaries, was not permitted to deduct those dividends in computing the domestic corporation's federal taxable income. Instead, a domestic corporation which received foreign subsidiary dividends could elect to claim, on the domestic corporation's federal

income tax return, a credit against its federal income tax for the foreign taxes paid. Alternatively, the Internal Revenue Code allowed a domestic corporation dividend payee who received foreign subsidiary dividends to claim a deduction for foreign taxes paid, rather than a tax credit, against its federal taxable income on its federal income tax return. Kraft elected the tax credit.

In 1981, Iowa imposed a corporation income tax, in Iowa Code Section 422.33, upon corporations carrying on all of their business in Iowa. In addition, the statute imposed the tax upon the income producing activities of all corporations, such as Kraft, which did business within and without Iowa.

The Iowa tax was imposed upon corporate "net income" as defined in Iowa Code Section 422.35 that was attributable to Iowa. Section 422.35 defined "net income" as the taxable income before the net operating loss deduction as properly computed for federal income tax purposes under the Internal Revenue Code of 1954, with certain adjustments, none of which are relevant to this case. Unlike the federal income tax scheme, Iowa did not permit a credit against a domestic corporation's Iowa income tax liability for income or other taxes paid to foreign governments. Since Section 422.35 is coupled with federal taxable income, if a corporate taxpayer elected to deduct taxes paid to foreign governments in determining its federal taxable income, it could likewise deduct such taxes in determining Section 422.35 net income.

In its 1981 federal income tax return, Kraft included the dividends declared by the foreign subsidiaries in its federal taxable income, as required by the Internal Revenue Code, and claimed a foreign tax credit against a portion of its federal income tax liability. In computing its Iowa net income in the preapportioned net income base, Kraft, on its 1981 Iowa income tax return, deducted the foreign subsidiary dividends from that base, contrary to

the requirements of Iowa Corporate Income Tax Law in Section 422.33(2)(b) and 422.35.

On June 3, 1985, the Director of the Department of Revenue and Finance issued a notice of assessment for Iowa corporation income tax against Kraft for its 1981 tax year. A portion of the assessed deficiency was based upon the effect of Kraft's exclusion of the foreign subsidiary dividends from Kraft's preapportioned net income base.

"CONCLUSIONS OF LAW"

This case involves judicial review under Iowa Code 17A, of a contested case proceeding in which the issues raised by the parties were beyond the authority of the agency to decide. In the administrative contested case proceeding before the Iowa Department of Revenue and Finance, its Director issued an order in which he stated that he lacked authority to decide Kraft's facial constitutional challenge to an Iowa corporate income tax assessment for 1981. "Where issues decided by an administrative agency involve potential constitutional questions, these constitutional issues must first be raised before the agency in order to be considered by a court in reviewing the final agency action under Iowa Code Section 17A.19 *Shell Oil Co. v. Bair*, 417 NW2d 425, 429 (1987). The Iowa Supreme Court has stated that notwithstanding the agency's lack of authority to make constitutional determinations, these issues are more effectively presented for adjudication based upon a specific factual record and the place for such a record to be developed is before the agency. *Id.* at 430.

Iowa Code Section 17A.19(1) provides, however, "that if an agency declines to issue a declaratory ruling after receipt of a petition therefor, any administrative remedy available under Section 17A.19 shall be deemed inadequate or exhausted." Since the Director of the Department of Revenue and Finance declined to determine the facial constitutional question, this is sufficient for satisfying the exhaustion waiver language in Section 17A.19(1). *Id.*

In determining the constitutionality of a statute, courts do not "pass on the policy, wisdom, advisability, or justice of a statute." *City of Waterloo v. Selden*, 251 NW2d 506, 508. In addition, "all presumptions are in favor of the constitutionality of the statute and it will not be held invalid unless it is clear, plain, and palpable that such decision is required." Plaintiffs have the burden to demonstrate beyond a reasonable doubt the act violates the constitutional provision and every reasonable doubt is resolved in favor of constitutionality. *Id.* "The presumption in favor of constitutionality is especially strong where, as here, the statute was enacted to promote a public purpose and relates to taxation." *Lee Enterprises Inc. v. Iowa State Tax Commission*, 162 NW2d 730, 739.

THIS COURT NOW DRAWS CERTAIN CONCLUSIONS:

I. The Iowa Tax Does Not Discriminate Against Interstate Commerce.

Kraft, Inc. challenges the constitutionality of Iowa's corporate income tax because corporate taxpayers doing business in Iowa with domestic subsidiaries receive a tax exemption while those like Kraft with subsidiaries abroad do not receive such an exemption. This is facially discriminatory in violation of the Commerce Clause, alleges Kraft, because corporations "are given a direct competitive advantage based upon whether they and their subsidiaries are engaged in interstate commerce as compared with those which are engaged in foreign commerce."

According to *Complete Auto Transit v. Brady* a state tax is not an impermissible burden on interstate commerce if it 1) it (sic) is applied to an activity with a substantial nexus with the taxing state 2) is fairly apportioned; 3) does not discriminate against interstate commerce; 4) and is fairly related to the services provided by the state. Kraft

does not challenge the fact that its business has a substantial nexus with Iowa, is fairly apportioned and is fairly related to services provided by the state. Instead, Kraft's challenge centers around the effect the tax has on interstate commerce and this Court will therefore concentrate on that aspect of the *Complete Auto* test only.

In supporting its claim that Iowa's tax is discriminatory, Kraft cites a number of cases in which the Supreme Court struck down a state tax held to be in violation of the Commerce Clause. The cases cited, however, all involve a state giving special treatment to a local in-state industry at the expense of an out-of-state industry. *Armco v. Hardesty*, 104 S.Ct. 2620 (Local manufacturers exempt from gross receipt tax on their sales at wholesale); *Tyler Pipe Industries v. Washington Dept. of Revenue*, 107 S.Ct. 2810 (1987) (Washington state gross receipts tax exempted in-state wholesale sales by a local manufacturer but taxed sales to out-of-state buyers); *Bacchus Imports, Ltd. v. Dias*, 104 S.Ct. 3049 (1984) (Hawaii exempted locally produced brandy and fruit wine from an excise tax imposed on liquor produced abroad); *Westinghouse Electric Corporation v. Tully*, 104 S.Ct. 1856 (1984) (tax credit limited to gross receipts of products shipped from New York). Kraft has not shown that the Iowa tax in any way benefited local in-state industry in detriment to out-of-state industry. Kraft attempts to fit the Iowa tax into the category of those found unconstitutional by stating that the discrimination does not have to be intentional to be unconstitutional. This is certainly true. But Kraft misses the next step in that if a state tax does not deliberately discriminate it must at least have the practical effect of discriminating against interstate commerce. Kraft has not shown this. The best that Kraft can do is to say that the Iowa tax is discriminatory because a corporation doing business in Iowa pays more corporate income tax if it has foreign subsidiaries than if it has domestic subsidiaries and this discrimination based on the residence is a violation of the Commerce

Clause. Assuming for the sake of argument that this is empirically true,[1] Kraft has not shown discrimination since this greater tax burden affects an in-state Iowa industry doing business abroad in the same way that it affects an out-of-state corporation like Kraft. Kraft has not shown that the Iowa tax exerts a pressure on interstate business to conduct more of its activities in Iowa. Despite this, Kraft argues that the Iowa tax is protectionist in that if all states had a tax scheme such as Iowa, it would be a "powerful persuader" to locate foreign operations within U.S. boundaries. Aside from the wholly speculative nature of this argument, Kraft's argument must fail because it overestimates the power of a state or this Court to do something about a situation that is the province of Congress. "Foreign commerce is preeminently a matter of national concern." *Japan Line* at 1821. "The threat of double taxation from foreign taxing authorities has no role in Commerce Clause considerations of multiple burdens. The Commerce Clause mandates apportionment among the several states but "apportionment among nations is a matter for international agreement; it should not be considered a limitation on a state's power to tax. *Sea Land*, 177 Cal. Rprtr. 448 (1974).

Even accepting Kraft's worst case scenario, this would be a case where independent state policy would have to yield to an overriding national interest. It is the legislature with the power granted by the Commerce Clause that would enact this legislation. *Moorman Manufacturing v. Bair*, 98 S.Ct. 2340, 2348 (1978). "The remedy for those who contend that legislation which is within constitutional bounds is unwise or oppressive is with the legislature." *City of Waterloo v. Selden*, 251 N.W.2d 506, 509.

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[1] It is not necessarily true since the total amount of income tax owed by the corporation doing business abroad would depend on the tax credits and deductions given by the foreign government. Therefore, it is not necessarily true that foreign commerce is disadvantaged. *Container Corp. of America v. Franchise Tax Bd.*, 103 S.Ct. 2952 (1983).

In fact, Congress has legislated in this area since it allows a tax credit or deduction for dividend income from foreign subsidiaries in the Internal Revenue Code. Kraft, however, has not set forth any language that evidences a Congressional intent to apply this to states and "absent some explicit directive from Congress, we cannot infer the treatment of foreign income at the federal level mandates identical treatment by the states." *Mobil Oil v. Commissioner of Taxes of Vermont*, 100 S.Ct. 1223, 1237 (180) (sic).

II. The Iowa Tax Does Not Impose an Impermissible Multiple Tax on Kraft.

Kraft correctly states that when a foreign instrumentality of commerce is at issue as it is here, two more prongs are added to the four already cited in *Complete Auto* in determining whether a state tax is constitutional. The first is the enhanced risk of multiple taxation. Second, a state tax on the instrumentality of foreign commerce must be scrutinized to make sure it does not impair federal uniformity in an area where federal uniformity is essential. *Japan Line Ltd. v. County of Los Angeles*, 99 S.Ct. 1813, 1820-1821 (1979). Kraft challenges the Iowa tax based on what it avers to be a risk of multiple taxation. Since Kraft has not raised the second issue of *Japan Line* of whether a tax will impair federal uniformity, it will not be discussed. Instead, this Court will discuss whether the tax creates a substantial risk of multiple taxation and is unconstitutional under the Commerce Clause.

Japan Line involved property taxes levied on Japanese-owned shipping companies engaged exclusively in foreign commerce. California levied the tax on the vessels even though the ships were there only intermittently and even though the ships were already taxed by their home ports in Japan. The Supreme Court held that the tax was unconstitutional because it subjected the Japanese Companies to multiple taxation. In order to prevent multiple taxation,

courts require that "taxes be apportioned among taxing jurisdictions, so that no instrumentality of commerce is subjected to more than one tax on its full value." *Id* at 1820. Kraft argues that the Iowa tax represents the fourth layer of taxes of its foreign subsidiary dividend income and is therefore unconstitutional under *Japan Line*. Kraft says that the dividend income was taxed by the foreign government on both the subsidiary and the domestic parent corporation, by the federal government, and, finally, by the Iowa corporate income tax. The multiple taxation prong of *Japan Line*, however, requires something more than simply adding up the income subject to tax as Kraft would have this Court do. As Respondent correctly points out, Kraft's bare listing of taxes is deceiving since the foreign government, rather than imposing two taxes, could have imposed one tax at a higher rate equivalent to the two. Further, the fact that Kraft is subject to taxing by a foreign government "does not conclusively demonstrate the existence of double taxation because [Kraft] has not produced its foreign tax returns, and it is entirely possible that deductions, exemptions, or adjustments in those returns eliminated whatever overlap in taxable income resulted from the application of the [Iowa] apportionment method." *Container Corp. of America v. Franchise Tax Bd.*, 103 S.Ct. 2933, 2952 (1983). The listing is also deceptive because it does not reflect the fact that Kraft received a credit on its federal income tax to offset the foreign taxes paid.

It is for the above reasons that the prohibition against multiple taxation is not an absolute rule but must instead "take into account the context in which the double taxation takes place and the alternatives reasonable (sic) available to the state." *Id.* at 2953. *Container Corp.* involved a refusal by a corporation which had a number of overseas subsidiaries to include its subsidiaries payroll, property, and sales in its California income tax apportionment. *Container Corp.* held that a California tax was constitutional

despite the fact that like the one in *Japan Line*, it resulted in double taxation to the corporation. Some of the income that was already taxed without apportionment by foreign nations as attributable to foreign subsidiaries was taxed by California as well as attributable to the state's share of the total income of the unitary business. *Container* at 2952. The court in *Container Corp.* found a number of distinctions between the tax at issue and the one in *Japan Line*. Unlike *Japan Line* the Court found that the double taxation was not the inevitable result of the California taxing scheme. *Id.* at 2952. It was also important to the Court's analysis that the tax fell on a corporation domiciled and headquartered in the United States rather than on foreign owners of an instrumentality of commerce. *Id.* It said it was unrealistic for California to avoid double taxation simply by not taxing Container Corp.'s income at all since this would be obviously unfair to the state. *Id.* This Court finds that the Iowa tax is more like the tax found to be constitutional in *Container Corp.* than the tax found to be unconstitutional in *Japan Lines* (sic).

Of great concern in *Japan Line* and the reason for the addition of the two prongs to the *Complete Auto* test was that the overlapping of tax was imposed on a foreign company in a foreign jurisdiction. This implicated "sensitive matters of foreign relations and natural sovereignty." *Japan Line* at 1825. While a foreign government might have some concern over how a domestically owned subsidiary that is doing business in its country is taxed at home, this concern is much more attenuated than it was in *Japan Line*. This Court finds that *Container Corp.* is directly applicable to the tax by the Iowa Department of Revenue and that the distinction between a tax on a domestically owned corporation engaged in foreign commerce and the tax at issue in *Japan Line* add up to a constitutionally significant difference. *Container* at 2952-2953. Important to this conclusion is the fact that the Supreme Court addressed a situation involving dividends like the

one at issue here in the *Container Corp.* opinion: "Moreover, once the Federal government has allowed a credit for foreign taxes on a particular intercorporate dividend, we are not persuaded why, as a logical matter, a State would have to grant another credit of its own, since the federal credit would have already vindicated the goal of not subjecting the taxpayer to a higher tax burden than it would have to bear if its subsidiary's income were not taxed abroad." 103 S.Ct. 2954, FN 30. This Court finds that like the tax at issue in *Container Corp.*, the Iowa tax is not an impermissible burden on foreign commerce.

Once Kraft's complaint that the Iowa tax results in multiple taxation is taken out of the context of the sensitive area of foreign relations and *Japan Line*, it essentially boils down to a complaint that since the federal government allows credits and deductions for taxes paid on foreign subsidiary dividends, Iowa should too. But Kraft sets forth no reason why this should be so. Concurrent federal and state taxation of income is a well-established norm. *Mobil Oil v. Comm'r of Taxes of Vermont*, 100 S.Ct. 1223, 1237 (1980). Kraft has not set forth any language from the legislative history mandating identical treatment of the dividend income for tax purposes and "absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the states." *Id.* See also *Shell Oil Company v. Iowa Dept. of Revenue*, 109 S.Ct. 278, 281 (1988).

In *Amerada Hess Corp. v. Director Division of Taxation*, thirteen major oil companies challenged a New Jersey corporate business tax that denied them the deduction on state income tax that they received under the federal windfall profits tax. The Supreme Court found that the tax did not violate any of the four tests of *Complete Auto* and therefore was constitutional, 109 S.Ct. 1617 (198) (sic). As there was no requirement that New Jersey give a tax credit or a deduction similar to the one given at the federal

level in *Amerada*, Iowa is similarly not required to give Kraft a tax credit that it received at the federal level. In fact, the Iowa Supreme Court dealt with this situation explicitly in *Shell Oil Co. v. Bair* where Shell argued that a state tax deduction for the federal windfall profit tax was constitutionally mandated. 417 N.W.2d 425 (Iowa 1987). The Iowa Supreme Court said that Shell's liability for the Iowa corporate income tax depended on the nexus of Shell's activities within this state and the fairness of the apportionment formula used in calculating it. While the preceding two factors must be validated, once it is determined that they are fair measurements for gross revenue purposes, "the extent to which these revenues may be reduced for tax purposes by allowable deductions is a matter of legislative grace." *Id.* at 430.

Kraft doesn't challenge the Iowa tax on the basis of insufficient nexus or unfair apportionment. Indeed, it would be hard pressed to do so in light of *Mobil Oil Corp. v. Com'r of Taxes of Vermont*, 100 S.Ct. 1223, 1226 (neither the foreign source of the income of a corporation nor the fact that it was received in the form of dividends from subsidiaries and affiliates precludes its taxability by a state) and *Moorman Manufacturing Company v. Bair*, (Iowa's method of calculating taxable income held to be fair apportionment and constitutionally acceptable) 98 S.Ct. 2340 (1978). Kraft simply has not shown that the aggregate sum which remains subject to tax, absent a credit for its foreign subsidiary taxes, is an invalid measurement of its Iowa income tax liability. *Shell Oil v. Bair*, 417 N.W.2d at 430-31. The tax credit at issue here, like the deduction in *Shell Oil* is therefore a "matter of legislative grace."

III. The Iowa Tax Does Not Violate The Equal Protection Clause.

Kraft next argues that the Iowa tax on corporations violates the Equal Protection Clause of the U.S. Constitution and Article 1, No. 6, of the Iowa Constitution. The

Complete Auto test encompasses due process standards. *Amerada*, 109 S.Ct. at 1625. Since the Iowa tax does not violate the four tests of *Complete Auto*, this Court also concludes that it does not violate due process. *Id.* Further, Kraft's reliance on *Metropolitan Life Ins. v. Ward* is inappropriate here since this Court has determined that the Iowa tax is not designed to favor industry within the state to the detriment of out-of-state corporations. In addition, the Iowa Department of Revenue and Finance rationale for adopting the Internal Revenue Code's definition of net income: "for the convenience of the taxpayer, as a savings to the state, and to provide the state with a means of verifying the accuracy and honesty of a taxpayer's return" is rationally related to a legitimate state purpose. 105 S.Ct. 1676 (1985).

In sum, this Court finds no constitutional infirmity with the Iowa Business Corporation Tax. Because this Court does not find the tax facially invalid as alleged by Kraft, there is no reason to reach the issue of whether the ruling should be prospectively applied to other taxpayers.

JUDGMENT

IT IS THE JUDGMENT OF THIS COURT that Kraft's Petition for Judicial Review is dismissed. Costs taxed to the Plaintiff.

8 September 1989 /s/ Theodore H. Miller
THEODORE H. MILLER, JUDGE
FIFTH JUDICIAL DISTRICT OF IOWA

A copy of this ruling has been
mailed to the attorneys for Kraft, Inc.
and to the attorneys for the Iowa
Department of Revenue and Finance.

APPENDIX C

**BEFORE THE IOWA STATE DEPARTMENT OF REVENUE AND FINANCE
HOOVER STATE OFFICE BUILDING
DES MOINES, IOWA**

DOCKET NO. 85-330-2A-A

ORDER

IN THE MATTER OF KRAFT, INC.
2211 SANDERS ROAD
NORTHBROOK, IL 60062

CORPORATE INCOME TAX ASSESSMENT

STATEMENT OF THE CASE

The instant contested case proceeding came on for hearing before the Director of Revenue and Finance on the 16th day of August, 1988. Present on behalf of the Protestor were John V. Donnelly and Harold N. Schneebeck, attorneys and authorized representatives for Protestor. Present on behalf of the Department of Revenue and Finance was Harry M. Griger, Special Assistant Attorney General and authorized representative of the Department.

Protestor offered in evidence the following portions of the Stipulation of the parties: paragraphs 1 through 21; paragraph 22 except for the portion denoted "Cross Examination" on page 13; paragraphs 23, 25, 26, 27(c), 32 and 33; and Exhibits 1 through 11 thereto. The Department offered in evidence the "Cross-Examination" portion of paragraph 22, on page 13, paragraphs 24, 27(a), (b) and (d) and 28 through 31 and paragraph 34 of the Stipulation and Exhibits A through J thereto. Protestor objected to the admission of paragraphs 24, 27(a), (b) and (d) and 28

through 31 and paragraph 34 of the Stipulation on the ground that they are irrelevant because there is no dispute between the parties as to the effect on Protestor of a decision favorable to it. Protestor also objected to the admission of Exhibits C through J to the Stipulation on the ground that they are irrelevant for the same reason.

The principal issue raised by the Protestor to be determined in this proceeding is whether the Iowa Business Tax on Corporations (Division III of Chapter 422, *Code of Iowa*) is unconstitutional on its face to the extent that it requires a Domestic Corporation to include in its "net income" (as that term is defined in § 422.35, *Code of Iowa*) dividends declared by its Foreign Subsidiaries whereas dividends declared by Domestic Subsidiaries are excluded from such net income. Other issues raised by the Protestor are: (i) whether the Iowa Business Tax on Corporations, considered with income taxes imposed by the United States and foreign governments with respect to such dividends declared by Foreign Subsidiaries and the income from which the dividends were declared, results in facially unconstitutional multiple taxation; and (ii) whether the Iowa Business Tax on Corporations to the extent of its treatment of dividends declared by Foreign Subsidiaries facially results in an unconstitutional contravention of the foreign policy of the United States and thereby denies to the federal government its constitutional role as the single controlling voice in foreign affairs. Specifically, this contested case proceeding involves the following provisions of the Constitution of the United States and/or the Constitution of the State of Iowa:

> Article I, Section 8, clause 3 of the Constitution of the United States (the Commerce Clause);
>
> The Due Process Clause of Section 1 of the Fourteenth Amendment to the Constitution of the United States;

The Equal Protection Clause of Section 1 of the Fourteenth Amendment to the Constitution of the United States;

The Supremacy Clause of Article VI, Clause 2 of the Constitution of the United States;

The Due Process Clause of Article I, Section 9 of the Constitution of the State of Iowa;

The uniform operation of laws provisions of Article I, Section 6 and Article III, Section 30 of the Constitution of the State of Iowa.

If the Iowa Business Tax on Corporations is found to be facially unconstitutional with respect to one or more of the issues raised by the Protestor, the Department raises the further issue to be determined in this proceeding of whether such a decision shall be applied to other taxpayers prospectively only, and, if so, the scope of any such prospective ruling.

FINDINGS OF FACT

The parties' Stipulation is hereby adopted as the Findings of Fact of the Director of Revenue and Finance. Said Stipulation is attached to this Order and incorporated herein by reference the same as if set forth in full. Protestor's objections to the admission of paragraphs 24, 27(a), (b) and (d) and 28 through 31 and paragraph 34 of the Stipulation and Exhibits C through J thereto offered by the Department are overruled.

CONCLUSIONS OF LAW

The Director of Revenue declines to render a decision in this case on the grounds that he has no authority to decide the facial constitutionality of statutes and, further, that he has no authority to decide whether any such decision should be applied prospectively only.

This Order is the final Order of the Director of Revenue and Finance and is subject to judicial review pursuant to §§ 422.41 and 422.29, *Code of Iowa*.

ISSUED at Des Moines, Iowa, this *18th* day of August, 1988.

IOWA DEPARTMENT OF REVENUE
AND FINANCE

By s/G.D.Bair
G. D. Bair, Director of
Revenue and Finance

APPENDIX D

BEFORE THE IOWA STATE DEPARTMENT OF REVENUE AND FINANCE HOOVER STATE OFFICE BUILDING DES MOINES, IOWA

DOCKET NO. 85-330-2A-A

STIPULATION

IN THE MATTER OF KRAFT, INC.
2211 SANDERS ROAD
NORTHBROOK, IL 60062

CORPORATE INCOME TAX ASSESSMENT

COME NOW the Iowa Department of Revenue and Finance and Kraft, Inc., and hereby stipulate and agree, for the purposes of this action only, that the following facts may be accepted as true and correct, that the documents attached hereto are true and genuine copies of the respective original documents and may be offered into evidence without further foundation, and that this stipulation shall constitute evidence in the above-captioned matter and in all proceedings for judicial review thereof, subject to the rights of either party to object on the grounds of relevance and to present additional evidence not inconsistent herewith:

1. Kraft, Inc., is a corporation duly organized and validly existing under the laws of the State of Delaware, with its principal office and commercial domicile located in the state of Illinois, and qualified to do business in the state of Iowa.

2. Kraft, Inc., was formerly named Dart & Kraft, Inc., and is the successor by merger to a former subsidiary of Dart & Kraft, Inc., which was also named Kraft, Inc. For

the purpose of clarity, the merged subsidiary shall hereinafter be referred to as "Old Kraft."

3. The Iowa Department of Revenue and Finance (hereinafter sometimes referred to as the "Department") is a duly constituted agency of the State of Iowa created effective January 1, 1968, by the Sixty-Second General Assembly of the Iowa Legislature as the successor to the State Tax Commission of Iowa and was reorganized pursuant to 1986 Iowa Acts, ch. 1245, §§ 401-450. G. D. Bair is the duly appointed Director of Revenue and Finance of the State of Iowa.

4. During the calendar year 1981, Old Kraft was a corporation duly organized and validly existing under the laws of the State of Delaware, with its principal office and commercial domicile located in the state of Illinois and qualified to do and doing business in the state of Iowa. Old Kraft constituted a unitary business, a portion of which was conducted in the state of Iowa.

5. Old Kraft filed an Iowa corporate income tax return for the calendar year 1981 and paid the amount of tax shown to be due thereon.

6. During the year 1981, Old Kraft owned capital stock representing more than eighty percent (80%) of the total voting power and total value of several corporations organized and conducting their respective businesses exclusively outside the United States, which corporations were not subject to United States income tax. For the sake of brevity, subsidiary corporations of this type will hereinafter sometimes be referred to in general as "Foreign Subsidiaries."

7. Attached hereto as Exhibit "1" is a schedule setting forth the names and nations of incorporation of certain Foreign Subsidiaries of Old Kraft which paid dividends to Old Kraft during 1981. The Foreign Subsidiaries listed in Exhibit "1" were required to pay, and in fact paid, to the

countries in which they were incorporated, income tax on that portion of their income from which the "dividends declared" shown in Exhibit "2" were paid (see also paragraph 16, *infra*).

8. Attached hereto as Exhibit "2" is a schedule setting forth: (i) the dividends declared to Old Kraft by the Foreign Subsidiaries listed in Exhibit "1" in the year 1981; (ii) the income taxes borne directly by Old Kraft, on account of said dividends, imposed by the nations of the dividend payors' incorporation, and withheld and remitted thereto by said payors (the "foreign income taxes withheld"); and (iii) the net amount [(i) less (ii)] that was repatriated to and received by Old Kraft.

9. For ease of reference, corporations organized and conducting their businesses exclusively outside the United States, which corporations are not subject to United States income tax, will hereinafter sometimes be referred to as "Foreign Corporations." Old Kraft's Foreign Subsidiaries were "Foreign Corporations" throughout 1981. Corporations organized under the laws of one of the states of the United States and subject to taxation under Chapter 1 of the Internal Revenue Code will hereinafter sometimes be referred to as "Domestic Corporations." Domestic Corporations whose dividends are "qualifying dividends" to recipient Domestic Corporations under section 243(b)(1) of the Internal Revenue Code will hereinafter sometimes be referred to as "Domestic Subsidiaries." The phrase "foreign governments" as used in this Stipulation means non-United States governments.

10. Domestic Corporations typically do business in foreign countries through corporations organized in the country in which they are doing business for a variety of reasons. Reasons include, but are not limited to, the requirements of the local country, a better ability to limit their liability in that country, the marketing advantage of being perceived by customers as a local company, greater

ease in repatriating funds, greater ease in borrowing funds locally, and ability to own property and manufacture in that country.

11. During the year 1981, §§ 241 and 243 of the Internal Revenue Code allowed a deduction in computing a Domestic Corporation's federal taxable income equal to 100% of the dividends it received from Domestic Corporations which were members of the same affiliated group of corporations (Domestic Subsidiaries). If the domestic dividend payor and payee were not members of the same affiliated group of corporations, the dividend payee was granted a deduction equal to 85% of the dividends it received from the domestic dividend payor.

12. During the year 1981, a Domestic Corporation which received dividends with respect to shares of stock which it owned in Foreign Corporations was not permitted to deduct such dividends in computing the Domestic Corporation's federal taxable income.

13. During the year 1981, the Internal Revenue Code permitted a Domestic Corporation which received dividends from Foreign Corporations to elect to claim on its (Domestic Corporation's) federal income tax return as a credit against its federal income tax a portion of the income and certain other taxes, if any, paid by the Foreign Corporations (dividend payors) to foreign governments as well as a portion of any foreign income taxes paid by the dividend payee (whether directly or by withholding) with respect to the dividend. The amount of the foreign tax credit available for use by the payee was limited by the Internal Revenue Code. Alternatively, the Internal Revenue Code permitted a Domestic Corporation (the dividend payee) to claim as a deduction on its federal income tax return the foreign income taxes withheld with respect to the dividend it received from Foreign Corporations in the determination of its federal taxable income.

14. During the year 1981, § 422.35, *Code of Iowa*, defined "net income" as the taxable income before the net operating loss deduction, as properly computed for federal income tax purposes under the Internal Revenue Code of 1954, with certain Iowa adjustments, none of which mentions dividends declared by Foreign Corporations.

15. During the year 1981, the Iowa Code did not permit a credit against a Domestic Corporation's Iowa income tax liability for income or other taxes paid to foreign governments with respect to dividends declared by Foreign Corporations to the Domestic Corporation.

16. In determining its taxable income for federal income tax purposes for the year 1981, Old Kraft included in its income computation: (i) the dividends declared by its Foreign Subsidiaries; and (ii) the foreign income taxes paid by the dividend-paying Foreign Subsidiaries on the income out of which the dividend was paid (the "gross-up"). In computing its federal income tax liability for 1981, Old Kraft claimed as a credit against its U.S. income tax an amount equal to a portion of the foreign income tax withheld with respect to the dividends plus a portion of the gross-up amount.

17. In computing its "net income" on its Iowa corporate income tax return for the year 1981, Old Kraft deducted from its federal taxable income: (i) the dividends declared to Old Kraft by the Foreign Subsidiaries during that year; and (ii) the gross-up included in Old Kraft's taxable income for federal purposes.

18. Under date of June 3, 1985, G. D. Bair, Director of Revenue of the State of Iowa, issued a Notice of Assessment for Corporation Income Tax against Old Kraft relating to its alleged liability for additional Iowa corporate income tax, interest and fees for the calendar year 1981. Said assessment assessed tax, interest and fees as follows:

Periods	Tax	Penalty	Interest	Fees	Total
81-12	$39,327,64(sic)	-	$12,427.53	1.45	$51,756.62

19. A portion of the deficiency in Iowa corporate income tax which was alleged in the Notice of Assessment to be owed by Old Kraft for the year 1981 was based on the assertion by the Department that for the year 1981 all dividend income declared by its Foreign Subsidiaries to Old Kraft should be included in the computation of the "net income" of Old Kraft under section 422.35, *Code of Iowa*. Also, the Department asserted that the income taxes withheld by foreign governments with respect to such dividends could not be deducted by Old Kraft in the computation of its "net income" because these taxes were not deducted by Old Kraft in the determination of its federal taxable income. Both parties agree that pursuant to Department Rule 701 Iowa Admin. Code 54.2(3), gross-up will not be used to augment Old Kraft's business income.

20. The dividend income declared by the Foreign Subsidiaries to Old Kraft is includable in Old Kraft's net income pursuant to § 422.35, *Code of Iowa*, and such dividend income is "business income" within the meaning of §§ 422.32(6) and 422.33(2)(b), *Code of Iowa*. Old Kraft constituted a unitary business, a portion of which was conducted in Iowa for 1981. The dividends declared by the Foreign Subsidiaries were part of Old Kraft's unitary business income.

21. Had Old Kraft's Foreign Subsidiaries been Domestic Corporations conducting their respective businesses exclusively outside the United States, the dividends which they declared to Old Kraft in 1981 would, under authority of the Internal Revenue Code, have been deducted in determining Old Kraft's federal taxable income and, therefore, in determining "net income" (as that term is defined in section 422.35, *Code of Iowa*) for Iowa income tax purposes.

22. If called as an expert witness in this case by Kraft, Inc., Roger Jacobsen would testify as follows:

DIRECT EXAMINATION

Q. Would you state your name, please?

A. Roger Jacobsen.

Q. And what is your address?

A. 3405 Woodland Avenue, West Des Moines.

Q. Mr. Jacobsen, what is your present occupation?

A. I am a partner with the public accounting firm of Peat Marwick Main.

Q. And in what office are you located?

A. The Des Moines, Iowa, office.

Q. Would you describe for us briefly what Peat Marwick Main and Company is and does?

A. It is a certified public accounting firm which deals with auditing, tax services and management consultants.

Q. How long have you been associated with Peat Marwick and Main?

A. Since 1971.

Q. And when did you become a partner?

A. 1980.

Q. In what areas do you concentrate your practice?

A. Primarily in the federal and state income tax area, dealing with commercial manufacturing clients.

Q. Is that the corporate income tax area?

A. Yes, corporate area.

Q. What college did you attend?

A. The University of Nebraska.

Q. What degree did you receive, if any?

A. Bachelor of Science in Business Administration, with a major in accounting in 1971.

Q. Do you hold any licenses or certificates connected with the accounting profession?

A. I am a Certified Public Accountant.

Q. Are you a member of any professional organizations?

A. Yes. I am a member of the American Institute of Certified Public Accountants and the Iowa Society of Certified Public Accountants.

Q. In connection with your profession, are you required to meet certain professional education requirements?

A. Yes, we are. The firm requirement is we have to have 20 hours of continuing education credits every year, with a minimum of 120 hours every three years.

Q. A 40-hour average, essentially?

A. That is correct.

Q. In what areas do you concentrate most of your continuing education?

A. Primarily in the commercial, corporate and partnership income tax area.

Q. Mr. Jacobsen, do you have any financial interest in Kraft, Inc., or any of its affiliates?

A. No.

Q. Are you an employee or officer of Kraft, Inc., or any of its affiliates?

A. No.

Q. Are Kraft, Inc., or any of its affiliates clients of Peat Marwick Main?

A. No, they are not.

Q. Are you being paid a fee in this case?

A. Yes, I am.

Q. Is your fee contingent in any manner on the results of this case?

A. No.

Q. Are you familiar with the pleadings, the Stipulation and exhibits which have heretofore been filed in this case?

A. Yes, I am.

Q. Now from your experience as a CPA, are you familiar with how dividends received by U.S. corporations from other corporations were treated for federal and Iowa income tax purposes during the year 1981?

A. Yes, I am.

Q. Mr. Jacobsen, this case concerns the treatment for Iowa corporate income tax purposes of dividends which United States corporations subject to Iowa income tax receive from what the parties have defined in the Stipulation as Foreign Subsidiaries. For ease of reference, may we refer to this type of dividend payor as a Foreign Subsidiary?

A. All right. Yes.

Q. Likewise, for ease of reference, may we refer to the dividend recipient as the Parent Corporation?

A. That would be fine.

Q. From your experience as a CPA, are you familiar with how dividends received by Parent Corporations from their Foreign Subsidiaries were treated for federal and Iowa income tax purposes during the calendar year 1981?

A. Yes, I am.

Q. Are you prepared to explain that treatment now?

A. Yes.

Q. Let me hand you what has been identified as Exhibit 3.

[Exhibit 3]

Can you explain what Exhibit 3 is?

A. It represents my depiction of a Domestic Corporation with a Domestic Subsidiary and a Foreign Subsidiary.

Q. Mr. Jacobsen, what are the assumptions you have made in preparing Exhibit 3?

A. Well, the assumptions we've made are that we've got a Parent Corporation with two 80% or more owned subsidiaries; one is a Domestic Subsidiary and one is a Foreign Subsidiary. Both of the subsidiaries have $200,000 worth of pretax income; they each paid $100,000 to their respective taxing jurisdictions, leaving $100,000 of after-tax income that would be available for a dividend distribution.

Q. Now, you and I have agreed to adopt the parties' definition of the Foreign Subsidiary. How are you defining Domestic Subsidiary for the purposes of your testimony?

A. A Domestic Subsidiary is one that is incorporated in one of the states of the United States.

Q. Let me hand you what has been identified as Exhibit 4.

[Exhibit 4]

Can you explain what Exhibit 4 is?

A. It is my calculation giving an example of the tax effects of a dividend received from a Domestic Subsidiary.

Q. Would you explain how a dividend declared by a Domestic Subsidiary was treated by its Parent Corporation for federal income tax purposes during 1981?

A. All right. This illustration is a dividend from a domestic subsidiary, and again our assumptions are that we start with the domestic subsidiary has $200,000 worth of pretax profit (sic). It paid U.S. tax of $100,000 and it's got after-tax profits of $100,000 available to pay a dividend. In fact, it does declare a dividend of $100,000 to its U.S. parent, and that dividend is picked up on the U.S. Parent's income tax return. The provision in the Internal Revenue Code in this case allows for a 100% exclusion, so there is no taxable income after that exclusion being recorded in the U.S. tax return.

Q. Now, you are referring to what has been identified as Exhibit 4?

A. Correct.

Q. So for federal income tax purposes, the Parent does not include any of the $100,000 dividend declared by its Domestic Subsidiary for federal income tax purposes?

A. That is correct.

Q. Would you please explain now how the dividend declared by the Domestic Subsidiary was treated by its Parent Corporation for Iowa income tax purposes during 1981?

A. All right. For Iowa income tax purposes we—we start with the federal taxable income, which in this case we said there was none because it was totally excluded for federal income tax purposes, so for Iowa purposes we also have none.

Q. This again is the bottom portion of Exhibit 4?

A. That is correct.

Q. So when a Domestic Subsidiary declares a dividend to its U.S. Parent, none of the dividend is includable in Iowa income?

A. That is correct.

Q. Let me hand you what has been identified as Exhibit 5.

[Exhibit 5]

Can you explain what Exhibit 5 is?

A. It is my calculation giving an example of the tax effect of a dividend received from a Foreign Subsidiary.

Q. Fine. Would you please explain now how a dividend declared by a Foreign Subsidiary was treated by its Parent Corporation for federal tax purposes during 1981?

A. This is our Exhibit 5, and again our assumptions are the same as the Domestic Subsidiary. The Foreign Subsidiary had $200,000 worth of pretax income, it paid $100,000 to its foreign jurisdiction or foreign government for income tax purposes, leaving $100,000 worth of after-tax income. The $100,000 actually was a dividend declared in this example and recorded for the U.S. Parent. In this case, the U.S. Parent also has to pick up a foreign tax paid by the Foreign Subsidiary, or referred to

as the gross-up, recording a total of $200,000 of income for tax purposes.

Q. I note there that you include in the Parent's federal taxable income $200,000. Is $100,000 of the dividend declared and $100,000 of an item you call gross-up? Can you explain briefly and as simply as you can what gross-up is?

A. Gross-up is the amount of foreign income tax that has been paid by the Foreign Subsidiary on its income from which the dividend was declared. It is included in the U.S. Parent's federal income, and provides the U.S. Parent with a credit against the Parent's tax for U.S. tax purposes.

Q. Now, gross-up is tax paid by the Foreign Subsidiary to one or more foreign governments?

A. That is correct.

Q. And that is the portion attributable to the dividend actually declared in favor of the Parent?

A. Again, correct.

Q. And it exists because of the tax credit given by the United States government?

A. That is correct. That is the mechanism for avoiding double taxation for U.S. tax purposes.

Q. Now, would you explain how a dividend declared by a Foreign Subsidiary was treated by its Parent Corporation for Iowa income tax purposes during 1981?

A. Again, on the bottom part of our Exhibit 5, we start with the $200,000 that is included in the federal taxable income. The State of Iowa allows the exclusion for the gross-up, or the $100,000, under Rule 54.2(3), leaving $100,000 subject to Iowa apportionment.

CROSS EXAMINATION

Q. Mr. Jacobsen, dividends, whether declared by a Domestic Subsidiary or a Foreign Subsidiary, are declared from the earnings of the subsidiary, isn't that correct, sir?

A. That is correct.

Q. And your testimony about the gross-up, which you indicated was included in federal taxable income, isn't the only reason for that is for purposes of calculation of the foreign tax credit (sic)?

A. That's correct.

Q. And if a corporation elects to deduct foreign taxes on its tax return rather than claim the foreign tax credit, gross-up never comes into play, does it?

Q. That is correct.

REDIRECT EXAMINATION

Q. One more brief question then, Mr. Jacobsen. When the Domestic Parent, the recipient of dividends, does not elect the federal foreign tax credit, then am I correct that this amount would be $100,000 in your example?

A. That is correct.

Q. And that the apportionable income would remain $100,000 for Iowa tax purposes?

A. That is also correct.

Q. So for Iowa tax purposes, it makes absolutely no difference whether the parent elects the federal foreign tax credit as far as what the bottom line is in your example?

A. Or income. That is correct.

23. Attached hereto are photocopies of the following:

Exhibit 6 - S. 1974, introduced in the U.S. Senate on December 18, 1985. This bill was not acted upon by the Congress.

Exhibit 7 - A three-page article from the February 12, 1986, edition of the *Daily Report for Executives*, published by the Bureau of National Affairs, Inc. This article contains a true and correct copy of the text of a letter dated January 30, 1986, from George P. Shultz, United States Secretary of State, to the governors of the States of Idaho, Montana, New Hampshire, Alaska, California and North Dakota.

Exhibit 8 - An eight-page letter dated March 5, 1986, from the Secretary of the Treasury, James A. Baker, III, to United States Senator Robert Packwood.

Exhibit 9 - A letter dated March 14, 1986, to California Assembly Republican Leader Pat Nolan from J. Roger Mentz, Acting Assistant Treasury Secretary (Tax Policy), published in the March 24, 1986, edition of *Tax Notes*.

Exhibit 10 - H.R. 2940, introduced in the U.S. House of Representatives on July 15, 1987.

Exhibit 11 - A press release issued January 21, 1988, by the Unitary Tax Campaign, which is a group of large United Kingdom corporations with operations in the United States and other foreign nations. Attached to the press release is a true and correct copy of "An Early Day Motion" referred to in the press release.

24. Iowa does not use the worldwide unitary combined reporting method to determine Iowa taxable income. The

executive branch of the Federal Government has not sued any State to stop inclusion of dividends declared by Foreign Subsidiaries in the State preapportionment net income base, is not involved in any judicial proceeding designed to preclude such inclusion, and has not otherwise ordered the States to stop such inclusion. The State Department of the Federal Government opposed such inclusion at the time that the Supreme Court considered *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983). The United States has no tax treaties which forbid inclusion of Foreign Subsidiary dividends in the preapportionment net income base of a Domestic Corporation and, at the time that this Stipulation was executed, the Congress has not enacted any legislation that specifically forbids or otherwise limits States from including dividends declared by Foreign Subsidiaries in the preapportionment net income base.

25. Pursuant to §§ 422.28 and 422.41, *Code of Iowa*, Old Kraft timely filed a protest with the hearing officer of the Department with respect to the assessment of additional corporate income tax, interest and fees contained in the Notice of Assessment.

26. In the event any of the issues in this case are decided in favor of Protestor, it and its former affiliate, Dart Industries, Inc. ("Dart"), shall, by reason of written agreements between Protestor and the Department and between Dart and the Department entered into in October 1986, have full use, benefit and advantage of such decision with respect to calendar year 1975 and all years thereafter as to Protestor and with respect to calendar year 1971 and all years thereafter as to Dart.

27. If Iowa Department of Revenue and Finance (Department) personnel were called as witnesses in this cause by the Department, they would testify as follows:

a. The Department has conducted a study of the amount paid of Iowa corporate income tax associated with dividends which are attributable to Foreign Sub-

sidiaries located in foreign countries and doing no business in the United States and which are included in the preapportionment business income base of the parent Domestic Corporation subject to Iowa corporation income tax. The Department's study estimates that historically $6 million per year in Iowa tax was paid and relates to these dividends. For a three-year period, there would be $18 million tax attributable to such dividends. The amount of interest that would be accrued on this $18 million amount, if it were subject to refund, would be approximately $2 million with interest computed through November 30, 1987, and such interest would be approximately $4 million with interest computed through December 31, 1988.

b. The amount of tax associated with the inclusion of these dividends in the preapportionment business income base of the parent Domestic Corporation subject to Iowa corporation income tax and which the Department has assessed to such Domestic Corporations but which has not been paid is approximately $4.2 million. However, a portion of such assessed tax was untimely assessed under the decision of the Iowa Supreme Court in *Kelly-Springfield Tire Co. v. Iowa State Board of Tax Review*, 414 N.W. 2d 113 (Iowa 1987). Therefore, the amount of timely assessed tax is approximately $2 million. The amount of interest is approximately $900,000 computed through November 30, 1987, which has accrued upon this $2 million of tax. The interest would be approximately $1.1 million computed through December 31, 1988. The amounts in this paragraph (b) are not included in paragraph (a).

c. The amount of Iowa tax associated with these dividends which the Department has assessed, which has been paid, and which, like Kraft, Inc., and Dart Industries, Inc., is subject to a specific agreement to refund in the event that the taxpayer successfully

challenged the validity of inclusion of such business income dividends in the Domestic Corporation's preapportionment income base is approximately $900,000. Of this amount, approximately $700,000 relates specifically to Kraft, Inc., and Dart Industries, Inc. However, a portion of such tax was untimely assessed under the decision of the Iowa Supreme Court in *Kelly-Springfield Tire Co. v. Iowa State Board of Tax Review*, 414 N.W. 2d 113 (Iowa 1987). Therefore, the amount of timely assessed tax is approximately $785,000, of which approximately $620,000 is attributable to Kraft, Inc., and Dart Industries, Inc. The amount of interest upon this $785,000, which the Department agrees would be refunded if Kraft, Inc., is successful in its constitutional challenge to the inclusion of these dividends in the preapportionment income base, would be $200,000 computed through November 30, 1987. The amount of interest would be $280,000 computed through December 31, 1988. The agreement between Kraft, Inc., and the Department was entered into on October 24, 1986, a copy of which is attached as Exhibit "A." The agreement between Dart Industries, Inc., and the Department was entered into on October 24, 1986, a copy of which is attached as Exhibit "B". The Department will honor these agreements and also agrees that, by reason of such agreement, any tax associated with Foreign Subsidiary dividends for subsequent years not expressly mentioned in the agreements by taxpayers within this paragraph (c) together with statutory interest will be refunded or payment will not be enforced, provided Kraft, Inc., is successful in its constitutional challenge to inclusion of these dividends in the preapportionment net income base. The amounts of tax associated with these dividends listed in this paragraph (c) are not included in the figures in paragraphs (a) and (b).

d. The total impact of *Kelly-Springfield* case upon Iowa corporate income tax revenues is set forth in Exhibit "C" attached to this stipulation.

28. If Iowa Department of Management personnel were called as witnesses in this cause by the Department, they would testify as follows:

a. As of October 31, 1987, the state budget, based upon Iowa revenues as estimated by the state revenue estimating conference created by Iowa Code § 8.22A and which become part of the unencumbered general fund, for the fiscal year ending June 30, 1988, is estimated to produce revenues of about $2.530 billion. This estimate does not take into account a decrease in Iowa revenues under the decision of the Iowa Supreme Court in *Kelly-Springfield Tire Co. v. Iowa State Board of Tax Review*, 414 N.W. 2d 113 (Iowa 1987). The above estimate of Iowa revenues which will become part of the unencumbered general fund, for the fiscal year ending June 30, 1988, does take into account the recent enactment by the Iowa legislature of House File 689, Acts of 72nd G.A., Special Session. As of October 31, 1987, it is estimated that the unencumbered general fund balance, on June 30, 1988, will be zero.

b. If the State of Iowa would have to refund in the fiscal year ending June 30, 1988, $20 million ($18 million tax and $2 million interest) in paragraph 27(a) and cancel the $2.9 million ($2 million tax and $900,000 interest) in paragraph 27(b), the estimated balance in the general fund, as of June 30, 1988, would be reduced by $22.9 million and to maintain a zero balance in the unencumbered general fund, there would have to be a corresponding reduction of expenditures and/or increase in Iowa revenues.

c. For the fiscal year ending June 30, 1989, it is estimated, as of October 31, 1987, that the $2.530 billion state budget for the prior fiscal year can be increased by 3 percent by reason of anticipated estimated economic growth in Iowa revenues for the fiscal year on the basis of current law which produces Iowa revenues. Even with such estimated growth, it is estimated that the unencumbered general fund balance, as of June 30, 1989, would be $800,000, unless revenues are increased and/or expenditures are reduced.

d. If the State of Iowa would have to refund in the fiscal year ending June 30, 1989, $22 million ($18 million tax and $4 million interest) in paragraph 27(a) and cancel the $3.1 million ($2 million tax and $1.1 million interest) in paragraph 27(b), the estimated balance in the general fund, as of June 30, 1989, would be reduced by $25.1 million. As of June 30, 1989, there would be an estimated deficit of at least $24.3 million, unless revenues are increased and/or expenditures are reduced.

e. In preparations of state budgets, the Department of Management relies upon taxes paid to the State of Iowa and tax assessments made by the Department of Revenue and Finance. The legislature, in approving the state budget, relies upon such taxes (including those Iowa corporate income taxes associated with dividends payable to Domestic Corporations by Foreign Corporations). The possible refunds for taxes associated with these dividends have never been built into state budgets for any fiscal year. By reason of the state of the economy in Iowa in the 1980s, a great reliance is placed on revenues projected for the Iowa state budgets.

29. The Department has projected that the State of Iowa would have collected approximately $894.1 million in the fiscal year ending June 30, 1988, from the Iowa individual income tax imposed for the calendar year 1987 under the provisions of Senate File 523 enacted by the 1987 First

Special Session of the 72nd General Assembly of the State of Iowa, which convened June 4, 1987, and adjourned June 6, 1987. This information was provided by the Department to the members of the General Assembly prior to the passage of Senate File 523.

The Department has projected that the State of Iowa will collect approximately $868.2 million in the fiscal year ending June 30, 1988, from the Iowa individual income tax imposed for the calendar year 1987 under the provisions of House File 689 enacted by the 1987 Second Special Session of the 72nd General Assembly of the State of Iowa, which convened and adjourned October 27, 1987. This information was provided by the Department to the members of the General Assembly prior to the passage of House File 689.

The Department has projected that the State of Iowa would have collected approximately $993 million in the fiscal year ending June 30, 1988, from the Iowa individual income tax for the calendar year 1987 if the General Assembly of the State of Iowa had conformed Iowa law to the provisions of the Internal Revenue Code of 1986 and not otherwise changed any other portion of the Iowa individual income tax law for that in effect for calendar year 1986. This information was provided by the Department to the members of the General Assembly prior to the passage of Senate File 523.

30. If Iowa Department of Revenue and Finance (Department) personnel were called as witnesses in this cause by the Department, they would testify as follows:

After the General Assembly enacted Senate File 523 and prior to enactment of House File 689, the state revenue estimating conference revised its general fund state budget revenue projections by an increase of $16 million for the fiscal year ending June 30, 1988. In addition, if House File 689 is extended by the 1988 session of the General Assembly and couples the Iowa individual income

tax to the Internal Revenue Code of 1986 for the 1988 tax year, an additional $9 million of individual income tax revenue associated with the 1988 tax year and with the fiscal year ending June 30, 1988, will accrue to the State's general fund. The members of the General Assembly requested the Department to use these revenue assumptions in forecasting a model which would approximate the $894.1 million projection associated with Senate File 523. The Department believes that these revenue assumptions explain why the General Assembly enacted House File 689 with a revenue projection of $868.2 million rather than one which would project $894.1 million.

31. If Legislative Services Bureau personnel were called as witnesses in this cause by the Department, they would testify as follows:

The following exhibits are in the custody of the Legislative Services Bureau and were available to members of the General Assembly prior to the October 27, 1987, second special legislative session which enacted House File 689:

a. Exhibit D which is an article in the September 7, 1987, issue of Forbes Magazine.

b. Exhibit E which are comments submitted to the State Tax Reform Study Committee by the Iowa Society of Certified Public Accountants.

c. Exhibit F which are comments submitted to the State Tax Reform Study Committee by the Iowa State Bar Association.

d. Exhibit G which are comments submitted to the State Tax Reform Study Committee by Rockwell International Corporation.

e. Exhibit H which are comments submitted to the State Tax Reform Study Committee by Speaker of the House Donald D. Avenson.

f. Exhibit I which are minutes and attachments thereto of the State Tax Reform Study Committee.

g. Exhibit J which is the final document, including final report and various attachments, of the State Tax Reform Study Committee.

32. The Department has jurisdiction of the parties in this proceeding.

33. The principal issue raised by the Protestor to be determined in this proceeding is whether the Iowa Business Tax on Corporations (Division III of Chapter 422, *Code of Iowa*) is unconstitutional on its face to the extent that it requires a Domestic Corporation to include in its "net income" (as that term is defined in §422.35, *Code of Iowa*) dividends declared by its Foreign Subsidiaries whereas dividends declared by Domestic Subsidiaries are excluded from such net income. Other issues raised by the Protestor are: (i) whether the Iowa Business Tax on Corporations, considered with income taxes imposed by the United States and foreign governments with respect to such dividends declared by Foreign Subsidiaries and the income from which the dividends were declared, results in facially unconstitutional multiple taxation; and (ii) whether the Iowa Business Tax on Corporations, to the extent of its treatment of dividends declared by Foreign Subsidiaries facially results in an unconstitutional contravention of the foreign policy of the United States and thereby denies to the federal government its constitutional role as the single controlling voice in foreign affairs. Specifically, this contested case proceeding involves the following provisions of the Constitution of the United States and/or the Constitution of the State of Iowa:

Article I, Section 8, clause 3 of the Constitution of the United States (the Commerce Clause);

The Due Process Clause of Section 1 of the Fourteenth Amendment to the Constitution of the United States;

The Equal Protection Clause of Section 1 of the Fourteenth Amendment to the Constitution of the United States;

The Supremacy Clause of Article VI, Clause 2 of the Constitution of the United States;

The Due Process Clause of Article I, Section 9 of the Constitution of the State of Iowa;

The uniform operation of laws provisions of Article I, Section 6 and Article III, Section 30 of the Constitution of the State of Iowa.

34. If the Iowa Business Tax on Corporations is found to be facially unconstitutional with respect to one or more of the issues in paragraph 33, the Department raises the further issue to be determined in this proceeding of whether such a decision can be applied to other taxpayers prospectively only, and, if so, the scope of any such prospective ruling.

Respectfully submitted,

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APPENDIX E

EXHIBIT 1

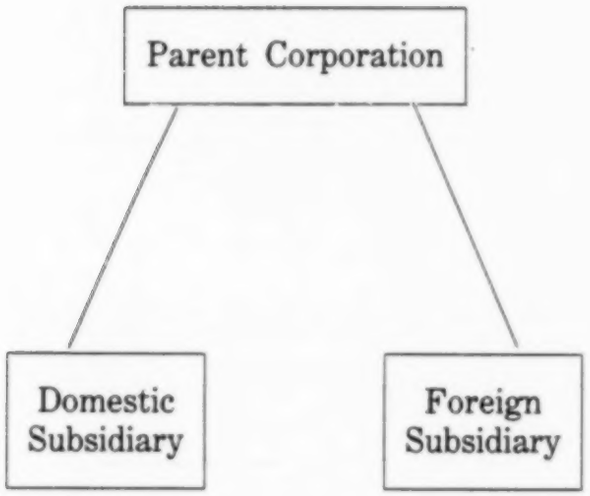
Relevant exhibits to the Stipulation follow. (All other exhibits are omitted.)

Company	Nation of Incorporation
Dominion Dairies Ltd.	Canada
Kraft Limited	Canada
Kraft Foods S/A	Denmark
Kraft G.m.b.H.	Germany
Kraft S.p.A.	Italy
Alimentos Kraft de Venezuela C.A.	Venezuela

EXHIBIT 2

	1981		
Company	Dividends Declared	Foreign Income Taxes Withheld	Dividends Received By Old Kraft
Dominion Dairies Ltd.	$ 1,903,139	$ 285,471	$ 1,617,668
Kraft Limited	4,924,944	738,742	4,186,202
Kraft Foods S/A	298,214	14,911	283,303
Kraft G.m.b.H.	727,287	109,093	618,194
Kraft S.p.A.	819,840	40,992	778,848
Alimentos Kraft de Venezuela C.A.	1,508,391	301,678	1,206,713
Total	$10,181,815	$1,490,887	$8,690,928

EXHIBIT 3



- Both Subsidiaries have income before tax of $200,000.
- Both Subsidiaries pay a tax to their respective taxing jurisdictions of $100,000.
- Both Subsidiaries have earnings after tax and available to be distributed to Parent Corporation of $100,000.

EXHIBIT 4

DIVIDEND DECLARED DOMESTIC SUBSIDIARY

	198 X	Year
	$ 200,000	Pretax Profit of Subsidiary
	(100,000)	U.S. Tax Paid by Subsidiary
	$ 100,000	After Tax Profit of Subsidiary
To U.S. Parent	$ 100,000	Declared Dividend by Subsidiary
U.S. Parent	$ 100,000	Dividend Income of Parent Corporation
	(100,000)	Dividend Deduction of the Parent Corporation for Federal Income Tax Purposes
	None	Dividend included in Parent Corporation's Federal Taxable income
Iowa Return	None	Portion of such Dividend includible in Parent Corporation's Iowa Return

EXHIBIT 5

DIVIDEND DECLARED
FOREIGN SUBSIDIARY

	198 X	Year
In U.S. Dollars	$ 200,000	Pretax Profit of Foreign Subsidiary
	(100,000)	Foreign Income Tax Paid by Foreign Subsidiary to Foreign Government
	$ 100,000	After-tax Profit of Foreign Subsidiary
U.S. Parent	$ 100,000	Dividend Declared by Foreign Subsidiary
	100,000	Foreign Tax Paid by Foreign Subsidiary (Gross-up)
	$ 200,000	Dividend Included in Parent Corporation's Federal Taxable Income
Iowa Return	$ 200,000	Portion of Such Dividend Included in Parent Corporation's Iowa Return
	(100,000)	Gross-up Excluded by Iowa Department of Revenue Rule 54.2(3)
	$ 100,000	Apportionable Income

APPENDIX F

IN THE SUPREME COURT OF IOWA

No. 89-1528

O R D E R

KRAFT, INC.,
Appellant,

vs.

IOWA DEPARTMENT OF REVENUE AND FINANCE,
Appellee.

After consideration by the court, en banc, appellant's Petition for Rehearing in the above-captioned case is hereby overruled and denied.

Dated this 19th day of March, 1991.

THE SUPREME COURT OF IOWA

/s/ Arthur A. McGiverin
Arthur A. McGiverin;
Chief Justice

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L O C A L

APPENDIX G

Sections 422.33 and 422.35 of the Iowa Code, as in effect in 1981, provided as follows:

422.33 Corporate tax imposed:

1. A tax is hereby imposed upon each corporation organized under the laws of this state, and upon every foreign corporation doing business in this state, annually in an amount computed by applying the following rates of taxation to the net income received by the corporation during the income year:

a. On the first twenty-five thousand dollars of taxable income, or any part thereof, the rate of six percent.

b. On taxable income between twenty-five thousand dollars and one hundred thousand dollars or any part thereof, the rate of eight percent.

c. On taxable income between one hundred thousand dollars and two hundred fifty thousand dollars or any part thereof, the rate of ten percent.

d. On taxable income of two hundred fifty thousand dollars or more, the rate of twelve percent.

2. If the trade or business of the corporation is carried on entirely within the state, or if the trade or business consists of the operation of a farm and the property is located entirely within the state, the tax shall be imposed on the entire net income, but if such trade or business is carried on partly within and partly without the state, or if the trade or business consists of the operation of a farm and the property is located partly within and partly without the state, the tax shall be imposed only on the portion of the net income reasonably attributable to the trade or business within the state, said net income attributable to the state to be determined as follows:

a. Nonbusiness interest, dividends, rents and royalties, less related expenses, shall be allocated within and without the state in the following manner:

(1) Nonbusiness interest, dividends, and royalties from patents and copyrights shall be allocable to this state if the taxpayer's commercial domicile is in this state.

(2) Nonbusiness rents and royalties received from real property located in this state are allocable to this state.

(3) Nonbusiness rents and royalties received from tangible personal property are allocable to this state to the extent that the property is utilized in this state; or in their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property is utilized. The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown, or unascertainable by the taxpayer tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payor obtained possession.

(4) Nonbusiness capital gains and losses from the sale or other disposition of assets shall be allocated as follows:

Gains and losses from the sale or the disposition of real property located in this state are allocable to this state.

Gains and losses from the sale or other disposition of tangible personal property are allocable to this state if the property had a situs in this state at the time of the sale or disposition or if the taxpayer's commercial domicile is

in this state and the taxpayer is not taxable in the state in which the property had a situs.

Gains and losses from the sale or disposition of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

b. Net nonbusiness income of the above class having been separately allocated and deducted as above provided, the remaining net business income of the taxpayer shall be allocated and apportioned as follows:

(1) Business interest, dividends, rents, and royalties shall be reasonably apportioned within and without the state under rules adopted by the director.

(2) Capital gains and losses from the sale or other disposition of assets shall be apportioned to the state based upon the business activity ratio applicable to the year the gain or loss is determined if the corporation determines Iowa taxable income by a sales, gross receipts or other business activity ratio. If the corporation has only allocable income, capital gains and losses from the sale or other disposition of assets shall be allocated in accordance with paragraph "*a*", subparagraph (4).

(3) Where income is derived from business other than the manufacture or sale of tangible personal property, the income shall be specifically allocated or equitably apportioned within and without the state under rules of the director.

(4) Where income is derived from the manufacture or sale of tangible personal property, the part attributable to business within the state shall be in that proportion which the gross sales made within the state bear to the total gross sales.

(5) Where income consists of more than one class of income as provided in subparagraphs (1) to (4) of this paragraph, it shall be reasonably apportioned by the busi-

ness activity ratio provided in rules adopted by the director.

(6) The gross sales of the corporation within the state shall be taken to be the gross sales from goods delivered or shipped to a purchaser within the state regardless of the f.o.b. point or other conditions of the sale, excluding deliveries for transportation out of the state.

For the purpose of this section, the word "sale" shall include exchange, and the word "manufacture" shall include the extraction and recovery of natural resources and all processes of fabricating and curing. The words "tangible personal property" shall be taken to mean corporeal personal property, such as machinery, tools, implements, goods, wares, and merchandise, and shall not be taken to mean money deposits in banks, shares of stock, bonds, notes, credits, or evidence of an interest in property and evidences of debt.

3. If any taxpayer believes that the method of allocation and apportionment hereinbefore prescribed, as administered by the director and applied to his business, has operated or will so operate as to subject him to taxation on a greater portion of his net income than is reasonably attributable to business or sources within the state, he shall be entitled to file with the director a statement of his objections and of such alternative method of allocation and apportionment as he believes to be proper under the circumstances with such detail and proof and within such time as the director may reasonably prescribe; and if the director shall conclude that the method of allocation and apportionment theretofore employed is in fact inapplicable and inequitable, the director shall redetermine the taxable income by such other method of allocation and apportionment as seems best calculated to assign to the state for taxation the portion of the income reasonably attributable to business and sources within the state, not exceeding,

however, the amount which would be arrived at by application of the statutory rules for apportionment.

4. In addition to all taxes imposed under this division, there is imposed upon each corporation doing business within the state a state minimum tax for tax preference equal to twenty-five percent of the state's apportioned share of the federal minimum tax. The state's apportioned share of the federal minimum tax is a percent equal to the ratio of the federal minimum tax on preferences attributable to Iowa to the federal minimum tax on all prefences. The director shall prescribe rules for the determination of the amount of the federal minimum tax on preferences attributable to Iowa which shall be based as much as equitably possible on the allocation and apportionment provisions of subsections 2 and 3. For purposes of this subsection, "federal minimum tax" means the federal minimum tax for tax preferences computed under sections 55 to 58 of the Internal Revenue Code of 1954 for the tax year.

422.35 Net income of corporation—how computed. The term "net income" means the taxable income before the net operating loss deduction, as properly computed for federal income tax purposes under the Internal Revenue Code of 1954, with the following adjustments:

1. Subtract interest and dividends from federal securities.

2. Add interest and dividends from foreign securities and from securities of state and other political subdivisions exempt from federal income tax under the Internal Revenue Code of 1954.

3. Where the net income includes capital gains or losses, or gains or losses from property other than capital assets, and such gains or losses have been determined by using a basis established prior to January 1, 1934, an adjustment may be made, under rules and regulations prescribed by

the director, to reflect the difference resulting from the use of a basis of cost or January 1, 1934, fair market value, less depreciation allowed or allowable, whichever is higher. Provided that the basis shall be fair market value as of January 1, 1955, less depreciation allowed or allowable, in the case of property acquired prior to that date if use of a prior basis is declared to be invalid.

4. Subtract fifty percent of the federal income taxes paid or accrued, as the case may be, during the tax year, adjusted by any federal income tax refunds; and add the Iowa income tax deducted in computing said taxable income.

5. Add the amount by which the basis of qualified depreciable property is required to be increased for depreciation purposes under the Internal Revenue Code Amendments Act of 1964 to the extent that such amount equals the net amount of the special deduction allowed on the basis of the amount by which the depreciable basis of such qualified property was required to be reduced for depreciation purposes under the Internal Revenue Code Amendments Act of 1962. The "net amount of the special deduction" shall be computed by taking the sum of the amounts by which the basis of qualified property was required to be decreased for depreciation purposes for the years 1962 and 1963 and subtracting from it the sum of the amounts by which the basis of such property was required to be increased, prior to 1964, for depreciation or disposition purposes under the Internal Revenue Code Amendments Act of 1962.

6. Subtract the amount of the work incentive programs credit allowable for the tax year under section 40 or the jobs tax credit allowable for the tax year under section 44B of the Internal Revenue Code of 1954 to the extent that the credit increased federal taxable income.

7. Subtract the amount of the alcohol fuel credit allowable for the tax year under section 44E of the Internal

Revenue Code of 1954 to the extent that the credit increased federal taxable income.

8. Add the amounts deducted as a result of the treatment provided sale-leaseback agreements under section 168(f)(8) of the Internal Revenue Code of 1954 to the extent that the amounts deduted are not otherwise deductible under the other provisions of the Internal Revenue Code of 1954.

9. Add the amount of windfall profits tax deducted under section 164(a) of the Internal Revenue Code of 1954.

10. If after applying all of the adjustments provided for in this section and the allocation and apportionment provisions of section 422.33, the Iowa taxable income results in a net operating loss, such net operating loss shall be deducted as follows:

a. The Iowa net operating loss shall be carried back three taxable years or to the taxable year in which the corporation first commenced doing business in this state, whichever is later.

b. The Iowa net operating loss remaining after being carried back as required in paragraph "a" of this subsection or if not required to be carried back shall be carried forward fifteen taxable years.

c. If the election under section 172(b)(3)(C) of the Internal Revenue Code of 1954 is made, the Iowa net operating loss shall be carried forward fifteen taxable years.

d. No portion of a net operating loss which was sustained from that portion of the trade or business carried on outside the state of Iowa shall be deducted.

Provided, however, that a corporation affected by the allocation provisions of section 422.33 shall be permitted to deduct only such portion of the deductions for net operating loss and federal income taxes as is fairly and equitably allocable to Iowa, under rules prescribed by the director.

APPENDIX H

Sections 243, 901, 902, 1504, and 7701 of the Internal Revenue Code, as in effect in 1981, provided as follows:

§ 243. Dividends received by corporations

(a) General rule

In the case of a corporation, there shall be allowed as a deduction an amount equal to the following percentages of the amount received as dividends from a domestic corporation which is subject to taxation under this chapter:

(1) 85 percent, in the case of dividends other than dividends described in paragraph (2) or (3);

(2) 100 percent, in the case of dividends received by a small business investment company operating under the Small Business Investment Act of 1958 (15 U.S.C. 661 and following); and

(3) 100 percent, in the case of qualifying dividends (as defined in subsection (b)(1)).

(b) Qualifying dividends

(1) Definition

For purposes of subsection (a)(3), the term "qualifying dividends" means dividends received by a corporation which, at the close of the day the dividends are received, is a member of the same affiliated group of corporations (as defined in paragraph (5)) as the corporation distributing the dividends, if—

(A) such affiliated group has made an election under paragraph (2) which is effective for the taxable years of its members which include such day, and either

(B) such dividends are distributed out of earnings and profits of a taxable year of the distributing corporation ending after December 31, 1963—

(i) on each day of which the distributing corporation and the corporation receiving the dividends were members of such affiliated group, and

(ii) for which an election under section 1562 (relating to election of multiple surtax exemptions) is not effective, or

(C) such dividends are paid by a corporation with respect to which an election under Section 936 is in effect for the taxable year in which such dividends are paid.

* * *

(5) Definition of affiliated group

For purposes of this subsection, the term "affiliated group" has the meaning assigned to it by section 1504(a), except that for such purposes sections 1504(b)(2), 1504(b)(4), and 1504(c) shall not apply.

* * *

§ 901. Taxes of foreign countries and of possessions of United States

(a) Allowance of credit

If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against the tax imposed by section 56 (relating to minimum tax for tax preferences), against the tax imposed for the taxable year under section 72(m)(5)(B) (relating to 10 per-

cent tax on premature distributions to owner-employees), against the tax imposed by section 402(e) (relating to tax on lump sum distributions), against the tax imposed for the taxable year by section 408(f) (relating to additional tax on income from certain retirement accounts), against the tax imposed by section 531 (relating to the tax on accumulated earnings), against the additional tax imposed for the taxable year under section 1351 (relating to recoveries of foreign expropriation losses), or against the personal holding company tax imposed by section 541.

(b) Amount allowed

Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) Citizens and domestic corporations

In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

* * *

§ 902. Credit for corporate stockholder in foreign corporation

(a) Treatment of taxes paid by foreign corporation

For purposes of this subpart, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends (determined without regard to section 78) bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes (other than those deemed paid).

* * *

§ 1504. Definitions

(a) Definition of "affiliated group"

As used in this chapter, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends, employer securities (within the meaning for section 409A(l)) while such securities are held under a tax credit employee stock ownership plan, or qualifying employer securities (within the meaning of section 4975(e)(8)) while such securities are held under a (sic) employee stock ownership plan which meets the requirements of section 4975(e)(7).

(b) Definition of "includible corporation"

As used in this chapter, the term "includible corporation" means any corporation except—

(1) Corporations exempt from taxation under section 501.

(2) Insurance companies subject to taxation under section 802 or 821.

(3) Foreign corporations.

(4) Corporations with respect to which an election under section 936 (relating to possession tax credit) is in effect for the taxable year.

[(5) Repealed. Pub. L. 94-455, title X, § 1053(d)(2), Oct. 4, 1976, 90 Stat. 1649.]

(6) Regulated investment companies and real estate investment trusts subject to tax under subchapter M of chapter 1.

(7) A DISC or former DISC (as defined in section 992(a)).

(c) Includible insurance companies

Notwithstanding the provisions of paragraph (2) of subsection (b)—

* * *

(d) Subsidiary formed to comply with foreign law

In the case of a domestic corporation owning or controlling, directly or indirectly, 100 percent of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for the purpose of this subtitle as a domestic corporation.

* * *

§ 7701. Definitions

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * *

(4) Domestic

The term "domestic" when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or of any State.

* * *

APPENDIX I

Section 1.1502-14(a)(1) of the Federal Income Tax Regulations, as in effect in 1981, provided as follows:

§ 1.1502-14. Stock, bonds, and other obligations of members.—(a) *Intercompany distributions with respect to stock*—(1) *Dividends.* A dividend distributed by one member to another member during a consolidated return year shall be eliminated. For purposes of this paragraph, the term "dividend" means a distribution which is described in section 301(c)(1) other than a distribution described in section 243(c)(1).

APPENDIX J

State Taxing Schemes

States That Do Not Start With Federal Taxable Income

Ala. Code §§ 40-18-34, -18-35(a)(14) (1985 & Supp 1990).

Ark. Code Ann. §§ 21-51-404(a)(1), (b)(9), -51-709 to -717 (1987 & Supp. 1989).

Cal. Rev. & Tax. Code §§ 24271, 24341, 25510 (West 1979 & Supp. 1991).

D.C. Code Ann. §§ 47-1803.1, -1803.2, -1810.1 to -1810.3 (1990).

Miss. Code Ann. §§ 27-7-13, -7-15 (1990).

Utah Code Ann. §§ 59-7-106, -7-106(2)(d), -7-108 (1987).

States Identical to Iowa

N.M. Stat. Ann. §§ 7-2A-2, 7-2A-2(C) (1988).

Vt. Stat. Ann. tit. 32, §§ 5811, 5811(18) (1981 & Supp. 1990).

States Similar to Iowa

Colo. Rev. Stat. §§ 39-22-304(1), -22-303(10)(b) (Supp. 1990).

Kan. Stat. Ann. §§ 79-32,138, -32,138(a), -32,138(c)(vi) (1989).

Me. Rev. Stat. Ann. tit. 36, §§ 5200-A, 5200-A(2)(G) (1990).

Mo. Ann. Stat. §§ 143.431, 143.431(1), (2) (Vernon 1976).

Okla. Stat. Ann. tit. 68, §§ 2353, 2353(10), 2358(A)(4)(b) (West Supp. 1991).

R.I. Gen. Laws §§ 44-11-11, -11-11(a), -11-12(1)(b) (1988 & Supp. 1990).

S.C. Code Ann. §§ 12-7-415, -7-1110, -7-1120(2) (Law. Co-op 1976 & Supp. 1990).

States With Noncomparable Variations

Alaska Stat. §§ 43.19.010 (art. III), 43.20.021, 43.20.065 (1990).

Idaho Code §§ 63-3022, -3022(e), (f), -3027B, -3027C(c)(1)(3) (1989 & Supp. 1990).

Mont. Code Ann. § 15-31-113 (1989 & Supp. 1990); *Baker Bancorporation Inc.* v. *Department of Revenue*, 202 Mont. 94, 657 P.2d 89 (1982).

N.H. Rev. Stat. Ann. §§ 77-A:1(III)(a), -A:3(II)(b), -A:4(IV) (Supp. 1990).

States That Exclude All Dividends

Ariz. Rev. Stat. Ann. §§ 43-1101(1), -1121(2), -1122(7) -1122(5) (Supp. 1990).

Conn. Gen. Stat. Ann. §§ 12-213, -217(a)(D) (West Supp. 1991).

Del. Code Ann. tit. 30, §§ 1903, 1903(a), 1903(a)(2) (1985 & Supp. 1990).

Fla. Stat. Ann. §§ 220.12, 220.13, 220.13(1), 220.13(1)(b)(2)(a), 220.13(d)(2) (West Supp. 1991).

Ga. Code Ann. §§ 48-7-21, -7-21(a), -7-21(b)(8)(A) (1982 & Supp. 1990).

Ill. Stat. Ann. ch. 120, ¶ 2, §§ 203, 203(b)(2)(O), 203(e)(1) (Smith-Hurd Supp. 1991).

Ind. Code Ann. §§ 6-3-1-3.5, -1-3.5(b), -2-12(b) to (e) (West 1989 & Supp. 1990).

Ky. Rev. Stat. Ann. §§ 141.010(12)(b), 141.010(13), 141.010(13)(b) (Michie 1991).

Md. Tax-Gen. Code Ann. §§ 10-304, -304(1), -307(d), -307(d)(1) (1988).

Mich. Stat. Ann. §§ 7.558(3)(3), 7.558(9)(7)(a) (Callaghan 1984 & Supp. 1990).

Neb. Rev. Stat. §§ 77-2734.04, -2734.04(6), -2716(5) (1990).

Ohio Rev. Code. Ann. §§ 5733.04(I), 5733.04(I)(2), (4) (Anderson Supp. 1990).

Pa. Stat. Ann. tit. 72, §§ 7401(3)(1)(a), (b) (Purdon 1990).

Va. Code Ann. §§ 58.1-402, -402(A), -402(C)(8), (10) (Supp. 1990).

W. Va. Code §§ 11-24-3a(24), -24-6, -24-6(c)(10)(A) (1987 & Supp. 1990).

States That Tax All Dividends Equally

Haw. Rev. Stat. §§ 235-2.3(a), 235-7(c), 235-7(c)(1)(3) (Supp. 1989).

La. Rev. Stat. Ann. §§ 243(A)(4), 287.65, 287.73(B)(3), 287.73(C)(1) (West 1990).

Mass. Gen. Laws Ann. ch. 60, §§ 30(5)(b), 30(5)(b)(i), 38(a)(1) (West 1988).

Minn. Stat. Ann. §§ 290.01 subd. 19, 290.01 subd. 19c(6), 290.21 subd. 4(a) to (b) (West 1989 & Supp. 1991).

N.J. Stat. Ann. §§ 54:10A-4(k), -4(k)(2)(B), -4(k)(5) (West Supp. 1991).

N.Y. Tax Law §§ 208.9, 208(9)(a)(1), (2), 208(9)(b)(2) (McKinney 1986 & Supp. 1991).

N.C. Gen. Stat. §§ 105-130.4(a)(1), -130.4(i), -130.5, -130.5(a)(7), -130.5(b)(3), -130.7(4) (1989 & Supp. 1990).

N.D. Cent. Code §§ 57-38-01(8), -38-01.3(1)(g), (i) (Supp. 1989).

Or. Rev. Stat. §§ 317.010(10), 317.267(1) to (2) (1989).

Tenn. Code Ann. §§ 67-4-805(a)(1), -4-805(b)(2)(A) (1989).

Wis. Stat. Ann. §§ 71.26(3), 71.26(3)(j) (West 1989 & Supp. 1990).

APPENDIX K

RULE 29.1 STATEMENT

The subsidiaries of petitioner other than wholly-owned subsidiaries are as follows:

464088 Ontario Ltd.

Abal Hermanos S.A.

Ajinomoto GF, Inc.

Artes Graficas Unidas S.A.

Australian Dried Fruit Agency

Bell Pack, Inc.

C.A. Tabacalera Nacional

Cafe Grand Mere

Cerveceria Nacional Dominicana C. Por A.

Ceylon Tobacco Company Limited

CIA Inversiones Puerto Plata S.A.

Cigarros La Tabacalera Mexicana S.A. de C.V.

Comptoir de La Confiserie SNC

Confederation of European Community Cigarette Manufacturer's Ltd.

Crippa e Berger Fonti Levissima

Dairy Industries (Jamaica) Ltd.

Dairy Industries Ltd.

Dong Mei Food Company Ltd.

Dong Suk Foods Corporation

Dong Suk Ginseng

Don Suk Oil & Fats Co. Inc.

E. Leon Jimenes C. Por A.

E.D. & F. Man (Bermuda) Ltd.

Fabrica de Cigarillos El Progreso S.A.

Fattorie Osella S.P.A.

Galas de Mexico S.A. de C.V.

German Merino y CIA Ltda

Godfrey Phillips India, Limited

Grundstuck Sgemeinschaft Jacobs Suchard

Guangtong Food Company Ltd.

HAG GF AG

Hamni Bank

Hostess Frito-Lay

Industria Licorera Hispanoamericana S.A.

Industrias Del Tabaco Alimentos y Bebidas S.A.

International de Vinos, S.A.

International Pet Foods Ltd.

International Tobacco Company Limited

ION S.A.

Jacobs Suchard AG

Jacobs Suchard Budapest GMBH

Jacobs Suchard Pavledes S.A.

Korea First Advertising Co. Ltd.

Kothari Corp. Ltd.

Kotsiopouli Bros.

L.W. de Mexico S.A.-de C.V.

LACTA

Lacteas Andaluzas S.A.
Lacteas La Ribera S.A.
Lakeland Daries Pty. Ltd.
Massalin Particulares S.A.
Maxpax S.A.
Mendiola y Compania, S.A.
Negroni Holding 93
Oper. International Nicoya
Oscar Mayer Cp Co. Ltd.
Philip Morris Espana S.A.
Pietro Negroni France S.A.
Pietro Negroni S.R.L.
Pietro Negroni U.K.
Premier Foods Corp.
Prima Meat Packers, Ltd.
Prmier Tobacco Industries Limited
Prolacteras S.A.
Proveedora Ecuatoriana S.A.
Pusan Insurance
Riespri Alicante S.A.
Riespri Madrid
Riespri Valencia S.A.
Riespri Zaragoza S.A.
Rothman, Benson & Hedges Inc.
Rothman's (UK) Limited
Sam Kwang Glass Co.

Sicma
Sociedad Agricola Comercial Ecuatoriana
Societa di Decaffeinizzazione
Societe Immobilere du 283 Rue de Rosny
Tabacalera Andina S.A.
Tabacalera Centroamericana S.A.
Tabacalera Costarricense, S.A.
Tabacalera de El Salvador S.A. de C.V.
Tabacalera Nacional, S.A.
Tabaco Rubio Ecuatoriano C.A.
Tabacos Norte S.A.
Tabamark S.A.
Taloca y CIA Ltda
Tian Mei Food Company Ltd.

Supreme Court, U.S.
FILED
JUL 15 1991
OFFICE OF THE CLERK

No. 90-1918

In The

Supreme Court of the United States

October Term, 1991

KRAFT GENERAL FOODS, INC.
(formerly KRAFT, INC.),

Petitioner,

vs.

IOWA DEPARTMENT OF REVENUE AND FINANCE,

Respondent.

Petition For Writ Of Certiorari To The Supreme Court Of Iowa

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTIONS PRESENTED FOR REVIEW

1. Whether the Iowa Business Tax on Corporations, which includes foreign subsidiary dividends in the tax base while excluding domestic subsidiary dividends from its base, is valid under the Commerce Clause because it does not advantage Iowa activity at the expense of non-Iowa activities and is justified by valid factors not related to economic protectionism.

2. Whether Iowa's treatment of dividends for the Iowa Business Tax on Corporations is valid under the Equal Protection Clause because it is rationally related to legitimate state purposes.

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STATEMENT OF THE CASE

The Respondent, Iowa Department of Revenue and Finance (Department), accepts Petitioner's statement of the case as substantially correct, but the following additional facts should be noted.

During the year 1981, the Internal Revenue Code permitted a domestic corporation which received dividends from foreign corporations to claim a federal income tax credit for a portion of the income and certain other taxes paid by the dividend payors to foreign governments and for a portion of any foreign income taxes paid by the dividend payee with respect to the dividend. Alternatively, the dividend payee was allowed to claim as a deduction on its federal income tax return the foreign income taxes withheld with respect to the dividends it received from foreign corporations. (App. 31a, Petition for Writ of Certiorari).

If a taxpayer elected to deduct foreign taxes to determine federal taxable income, it would also deduct such taxes to calculate Iowa Code § 422.35 net income. Section 422.35 defined "net income" as the taxable income before the net operating loss deduction as properly computed for federal income tax purposes under the Internal Revenue Code, with certain adjustments, none of which are relevant to this case. (App. 32a, Petition for Writ of Certiorari).

In the District Court, the only prongs of the Commerce Clause test argued by Kraft were the discrimination against foreign commerce and multiple taxation

prongs. Kraft abandoned the issue of an alleged unconstitutional interference by Iowa with United States foreign policy.

The District Court, in addition to what is noted in Kraft's Statement, found that Kraft had "not shown that the Iowa tax exerts a pressure on interstate business to conduct more of its activities in Iowa." (App. 17a, Petition for Writ of Certiorari).

In the Iowa Supreme Court, Kraft abandoned the multiple taxation question. The only Commerce Clause issue presented to the Iowa Supreme Court was whether the Iowa corporate income tax structure unconstitutionally discriminates against foreign commerce. (App. 5a, Petition for Writ of Certiorari). The Iowa Supreme Court held that there was no unconstitutional discrimination against foreign commerce because there was no showing "that Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme." (App. 7a, Petition for Writ of Certiorari).

Dividends, whether declared by a domestic subsidiary or a foreign subsidiary, are declared and payable from the earnings of the subsidiary. (App. 41a, Petition for Writ of Certiorari).

The foreign subsidiaries which paid the dividends involved in this case were part of Kraft's unitary business, a portion of which was conducted in Iowa. (App. 33a, Petition for Writ of Certiorari). The foreign subsidiary dividends, therefore, constituted a portion of Kraft's apportionable unitary business income. (App. 33a, Petition for Writ of Certiorari).

SUMMARY OF THE ARGUMENT

The only prong of the Commerce Clause test at issue in this case is the discrimination prong. Including foreign subsidiary dividends in the apportionable income for the Iowa Business Tax on Corporations, while excluding domestic subsidiary dividends, does not violate the Commerce Clause by unconstitutionally discriminating against foreign commerce. It does not favor any Iowa activity at the expense of non-Iowa activities. It does not provide a commercial advantage to local business, encourage the diverting of new business to Iowa or operate as a disincentive for existing instate business to move elsewhere. As a unitary business' Iowa activities increase, more of its unitary earnings will be included in Iowa net income. Therefore, out-of-state commerce is actually favored at the expense of local commerce. The Iowa tax system does not discourage the incorporation of foreign subsidiaries. If every state adopted the Iowa unitary taxation method, the unitary earnings of domestic subsidiaries could be subject to greater tax than would be the foreign subsidiary earnings. A unitary business is not taxed more harshly by Iowa if it is engaged in foreign commerce than if it is engaged in interstate or intrastate commerce.

The difference in Iowa's treatment of foreign and domestic dividends is a byproduct of Iowa's decision to use the federal taxable income figure as the starting point for computing Iowa net income. Use of the federal taxable income figure results in benefits to taxpayers and the State. Therefore, the Iowa tax treatment of dividends is justified by a valid factor unrelated to economic protectionism.

Coupling Iowa's tax base to federal taxable income serves legitimate state purposes. Because Iowa's treatment of dividends is a byproduct of that coupling, it is rationally related to legitimate state purposes. Therefore, it does not violate the Equal Protection Clause.

REASONS TO DENY THE PETITION

I. IOWA'S TREATMENT OF DIVIDENDS DOES NOT UNCONSTITUTIONALLY DISCRIMINATE AGAINST FOREIGN COMMERCE.

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977), articulates a four-prong test to evaluate whether a state tax violates the Commerce Clause with respect to state taxation of interstate commerce. A state tax will be sustained "against Commerce Clause challenge when the tax is [1] applied to an activity with a substantial nexus with the taxing state, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." 430 U.S. at 279. In the event that the state tax is imposed upon foreign commerce, rather than interstate commerce, the test includes the four prongs in *Complete Auto* and, in addition, the considerations of "the enhanced risk of multiple taxation" and whether the state tax "prevents the Federal Government from speaking with one voice" in foreign affairs. *Container Corporation v. Franchise Tax Board*, 463 U.S. 159, 185, 193 (1983); *see Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 446, 448 (1979).

Of the above six prongs, Kraft has confined its argument to a consideration of only one. This is the discrimination prong. (App. 5a, Petition for Writ of Certiorari).

Kraft contends that Iowa's tax system discriminates illegally against foreign commerce. All of the remaining prongs are not at issue and Iowa's tax laws must be presumed not to violate them. If the Court believes it is necessary to review a case involving different treatment of dividends depending on whether they are paid by a foreign or domestic subsidiary, a better case for review would be one where more of the six prongs of the test are before the Court for consideration.

Kraft states that the "question to be resolved is whether a state taxing scheme that facially discriminates against foreign commerce must be shown to favor *intrastate commerce*, rather than *domestic commerce* generally, in order to be held unconstitutional." (Kraft Pet. at 9). Kraft further states that the "Iowa courts concluded that a showing of discrimination in favor of *intrastate commerce* was required before a state tax on foreign commerce could be considered unconstitutional under the Foreign Commerce Clause." (Kraft Pet. at 9). Kraft has mischaracterized the question to be resolved and the Iowa Supreme Court's decision. The Iowa Supreme Court held that in order to show unconstitutional discrimination against foreign commerce, Kraft must show "that Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme." (App. 7a, Petition for Writ of Certiorari). If Iowa businesses received a commercial advantage, the Iowa Court would have found the Iowa taxing scheme unconstitutional even if those Iowa businesses were engaged in interstate and/or foreign commerce, as opposed to intrastate commerce. The key to the Iowa Court's decision was that no local Iowa activity was advantaged (whether that activity was part

of intrastate, interstate, or foreign commerce) over non-Iowa activities.

A. The Iowa Tax Structure Does Not Violate The Discrimination Prong Because It Does Not Advantage Any Local Iowa Activity At The Expense Of Non-Iowa Activities Or Otherwise Violate The Purposes Of The Commerce Clause.

The Commerce Clause was a dominant theme at the Constitutional Convention called for the purpose of drafting the United States Constitution. In *Wardair Canada v. Florida Department of Revenue*, 477 U.S. 1, 7 (1986), this Court stated:

> As we have previously observed: "The few simple words of the Commerce Clause . . . reflected a central concern of the Framers that was an immediate reason for calling the Constitutional Convention: the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation."

The vice of the "economic balkanization" affecting economic relations between the states was discrimination against commerce which crossed state lines. Therefore, the Commerce Clause was intended to prevent discrimination against such commerce "providing a direct commercial advantage to local business." *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 268 (1984); *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 329 (1977). State tax schemes which tend to encourage the diverting of new business to the taxing state or operate as a disincentive

for existing instate business to move elsewhere are discriminatory under the Commerce Clause in that they foreclose "tax-neutral" decisions by creating an advantage for instate business. *Westinghouse Electric Corporation v. Tully*, 466 U.S. 388, 406 (1984).

In each Supreme Court case relied upon by Kraft in support of its Commerce Clause discrimination argument, the state taxing scheme favored some instate activity over an activity performed partly or wholly outside the taxing state. In those cases, the state taxing scheme engaged in the very economic balkanization which the Commerce Clause was intended to avoid. "A tax is generally said by the Court to be discriminatory when the taxing State provides a commercial advantage to local business at the expense of out-of-state business." P. Hartman, *Federal Limitations on State and Local Taxation* § 2:19, at 50 (Supp. 1990).

State taxes are discriminatory under the Commerce Clause if instate activities are treated more favorably at the expense of similar activities which cross state lines or where the discrimination interferes with economic decision-making by encouraging the conduct of activities in the taxing state. Tatarowicz and Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 Vand. L. Rev. 879, 898 (May 1986). Iowa's inclusion of unitary foreign subsidiary dividends in the preapportioned net income base and exclusion of domestic subsidiary dividends from that base does neither. The Iowa tax structure does not encourage, protect, or otherwise advantage instate activities at the expense of out-of-state activities. Indeed, the opposite is generally true. The following examples will illustrate these points.

Dividends payable to Kraft or any other parent corporation are paid from the subsidiary's earnings. (App. 41a, Petition for Writ of Certiorari). The unitary subsidiary, whether foreign or domestic, is merely an extension of the parent corporation's overall unitary business. *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980); (App. 30a par. 10, Petition for Writ of Certiorari). As will be shown, as a unitary business' Iowa activities increase, more of the unitary earnings will be included in Iowa net income, resulting in greater taxation of those earnings.[1]

Assume that the parent corporation, A, and its wholly owned domestic subsidiary, B, have a unitary relationship and do all of their business in Iowa. Here, all of the earnings of the unitary business will be subject to Iowa taxation, even though none of the dividends declared by B would, under Iowa Code § 422.35, be taxable to A. Under this greatest exposure of the unitary earnings to Iowa, the result is taxation of 100 percent of those earnings, albeit there are two different taxpayers, namely, A and B. If A had a wholly owned unitary foreign subsidiary, C, located solely in a foreign country,

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[1] "It is not a purpose of the Commerce Clause to protect state residents from their own state taxes." *Goldberg v. Sweet*, 488 U.S. 252, 266 (1989). Likewise, the Commerce Clause "is not designed to protect local commerce." Tatarowicz and Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 Vand. L. Rev. 879, 926 (May 1986).

Iowa would only tax a portion of C's earnings as represented by dividends declared and paid to A. If A dissolved B and incorporated B under the laws of a foreign country to only engage in business activities in that foreign country, Iowa would tax A on a portion of the unitary foreign earnings as represented by the dividends declared by B, but such tax is obviously less than the tax upon 100 percent of B's earnings that occurred when B was wholly located in Iowa. Under the circumstances in this example, there is no discrimination that the Commerce Clause was designed to alleviate, because there is no commercial advantage to local business at the expense of non-Iowa business. Indeed, non-Iowa business is advantaged over local Iowa business under the Iowa unitary business tax structure.

Assume that parent corporation D does all of its business in Iowa and that it has two wholly owned unitary subsidiaries, E and F. Assume that E is a domestic subsidiary and F is a foreign subsidiary located wholly in a foreign country. Assume that E does a portion of its business in Iowa and a portion outside of Iowa. Assume E and F pay dividends to D. Here, again, more earnings of D and E, which have income producing activities in Iowa, than earnings of F, which has no Iowa activities, are included in the preapportioned net income bases of D and E. In this example, D's earnings are fully taxed to D by Iowa. E's earnings are partly taxed to E by Iowa, but are fully in E's preapportioned net income base. The dividends declared by F are in D's tax base, but the dividends do not represent all of F's earnings. Thus, because of D's and E's Iowa activities, a greater portion of their earnings are capable of being taxed by Iowa than F's

earnings. As in the prior example, there is no tax advantage for in-state activities at the expense of out-of-state activities.

Assume that parent corporation G does business partly within and partly without Iowa. Assume that G has a wholly owned unitary foreign subsidiary, H, located entirely in a foreign country and obtains dividends from H. Under these circumstances, G's preapportioned net income base includes G's operating income and the dividends declared by H. Assume that parent corporation I, like G, does business partly within and partly without Iowa. Assume that I has a wholly owned unitary domestic subsidiary, J, which does no business in Iowa. The dividends declared by J are not in I's preapportioned net income base under § 422.35 and, thus, are not included in the determination of I's income attributable to Iowa. (App. 33a par. 21, Petition for Writ of Certiorari). Yet, here again, instate Iowa activities are not encouraged, protected, or otherwise advantaged in comparison to non-Iowa activities. The difference in treatment of the dividends declared by H and those declared by J, and the corresponding difference in treatment of the unitary businesses of G and I are unrelated to any local Iowa activity. The treatment of dividends does not encourage G or I to locate either H's or J's activities in Iowa. The opposite is true, because if either H or J was located in Iowa, Iowa's tax on the unitary earnings would likely increase. There is no economic balkanization, adverse to the Commerce Clause, in this example. There is no direct commercial advantage to local Iowa business at the expense of non-Iowa business.

> The commerce clause may be viewed as a protection from local biases against either interstate or foreign commerce. Thus, it can be concluded that not only negative effects on protected commerce, but also positive effects on local commerce are necessary to find a statute unconstitutional under the commerce clause.

Tatarowicz and Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 Vand. L. Rev. 879, 941 (May 1986). Because the Iowa treatment of dividends, within the context of its treatment of unitary earnings, does not favor Iowa activities over those which cross state lines and does not encourage or protect the conduct of activities in Iowa, the Iowa tax structure does not discriminate against foreign commerce in violation of the Commerce Clause. While state taxes which discriminate against interstate or foreign commerce to benefit instate activities are invalid, "state taxes which favor out-of-state commerce at the expense of local commerce are not similarly suspect." L. Tribe, *American Constitutional Law* § 6-16, at 354-55 (1978).

Kraft relies heavily upon *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318 (1977). In that case, a New York stock transfer tax scheme discriminated between different types of interstate commerce. The Supreme Court expressly considered "the question whether a State may tax in a manner that discriminates between two types of interstate transactions *in order to favor local commercial interests* over out-of-state businesses." 429 U.S. at 335 (emphasis added). If the favoring of local commercial interests was not a critical factor, the Court would have had no reason to mention it. Because no Iowa "commercial interests" are favored by the Iowa

treatment of unitary earnings, including dividends, *Boston Stock Exchange* is not supportive of Kraft's position.

Kraft relies upon *Hale v. Bimco Trading, Inc.*, 306 U.S. 375 (1939), which invalidated a Florida law providing for an inspection fee for foreign cement but not for cement produced in the United States. In *Bimco Trading*, however, the Court emphasized that local Florida-produced cement was being protected from competition by foreign-produced cement. It was because of this local instate bias that the law was invalidated.

Kraft relies upon *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), in which a California property tax was invalidated as applied to shipping containers of a Japanese taxpayer whose home port was in Japan and whose containers were fully taxed there. The Supreme Court noted that if the *Complete Auto* four-prong test applied, the "Commerce Clause inquiry would be at an end." 441 U.S. at 445. The Court noted that when the state tax involves foreign commerce, "two additional considerations, beyond those articulated in Complete Auto, come into play." 441 U.S. at 446. These are, first, "the enhanced risk of multiple taxation" and, second, the impairing of "federal uniformity in an area where federal uniformity is essential." 441 U.S. at 446, 448. But, these "considerations" are not before this Court, because Kraft's constitutional attack is confined to the discrimination prong of *Complete Auto*. As the Iowa Supreme Court recognized, "*Japan Line, Ltd.* did not involve discrimination against foreign commerce, which is the basis of Kraft's commerce clause argument." (App. 7a, Petition for Writ of Certiorari). In the appropriate case, this Court may want to analyze a tax that has no instate biases using

the two additional factors set forth in *Japan Line*. This is not such a case, because Kraft has waived any challenge to the Iowa tax based on those factors.

Cook v. Commonwealth of Pennsylvania, 97 U.S. 566 (1878), discussed by Kraft, does not support Kraft's argument. In *Cook*, a Pennsylvania tax was imposed on sales by auctioneers, with an exception for "groceries, goods, wares and merchandise of American growth or manufacture." *Id.* at 569. Obviously, goods made or grown in Pennsylvania were exempted from the tax, because Pennsylvania is part of America. The tax exemption favored Pennsylvania enterprises at the expense of foreign businesses. The Court stated that, by way of the Commerce Clause,

> the framers of the Constitution believed that they had sufficiently guarded against the dangers of any taxation by the States which would interfere with the freest interchange of commodities among the people of the different States, and by the people of the States with citizens and subjects of foreign governments.

Id. at 574. The Iowa treatment of dividends does not interfere with the free interchange of commodities among people of different states or by Americans with citizens and subjects of foreign governments.

The state court cases relied upon by Kraft are unpersuasive with respect to the discrimination issue. Kraft relies upon *Miller v. Publicker Industries, Inc.*, 457 So. 2d 1374 (Fla. 1984). In *Publicker*, a tax exemption which was limited to gasohol containing ethyl alcohol distilled from United States agricultural products or byproducts violated the Import-Export Clause and the Commerce

Clause. The Florida Court's Commerce Clause discussion is contained in a single paragraph, and no mention is made of whether invalid Commerce Clause discrimination should be analyzed in terms of a local instate bias. Because the tax favored local Florida agricultural products over foreign agricultural products, *Miller* did contain a local instate bias, unlike the situation in the instant case.

Kraft relies on the California cases of *Zee Toys, Inc. v. County of Los Angeles*, 85 Cal. App. 3d 763, 149 Cal. Rptr. 750 (1978), *aff'd by an equally divided Court, sub nom. Sears, Roebuck and Co. v. County of Los Angeles*, 449 U.S. 1119 (1981), and *Star-Kist Foods, Inc. v. County of Los Angeles*, 227 Cal. Rptr. 391, 42 Cal. 3d 1, 719 P.2d 987 (1986), *cert. denied*, 480 U.S. 930 (1987). Those cases involved an exemption from an ad valorem property tax for business inventories of foreign origin or destination which were transshipped through the state. In *Container Corporation v. Franchise Tax Bd.*, 463 U.S. 159, 188-89 (1983), the distinction between a tax on income and a tax on property was one of three distinctions adding up to a "constitutionally significant difference" between the *Container* and *Japan Line* cases. Also, the California property tax exemption gave foreign goods a "competitive advantage over interstate goods of the same nature and competing in the same market." *Zee Toys*, 149 Cal. Rptr. at 757. The Iowa income tax treatment of dividends, including unitary foreign dividends in the apportionable tax base but not unitary domestic dividends, does not favor any Iowa or other states' goods over foreign goods. Another distinction is that the California Courts were concerned that the California exemption statute at issue in *Zee Toys* and *Star-Kist*

might interfere with federally imposed tariffs designed to protect United States manufactured goods threatened by foreign competition. *Zee Toys*, 149 Cal. Rptr. at 757-58; *Star-Kist*, 719 P.2d at 995. No such concern can exist in this case. Finally, although the California Courts purported to rely on *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318 (1977), they apparently did not give sufficient weight to the *Boston Stock Exchange* language that discrimination between two types of interstate transactions is not allowed when done "in order to favor local commercial interests." *Boston Stock Exchange*, 429 U.S. at 335.[2]

Kraft asserts that the Iowa taxing scheme "clearly favors corporations that conduct their unitary business operations through domestic subsidiaries." (Kraft Pet. at 15). This is pure speculation. It has not been demonstrated that the tax burden upon domestic unitary earnings is less than upon foreign earnings.[3] There is no basis

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[2] The dissent in *Star-Kist* recognized that

> [u]nlike *Boston Stock Exchange, Westinghouse Electric,* and *Maryland v. Louisiana,* supra, no burden was imposed on interstate commerce by placing a penalty or disincentive on the choice to transact business in another state. Moreover, unlike the paradigm commerce clause case, local interests are not favored. (See *Westinghouse Electric,* supra, 466 U.S. at p. 403, 104 S.Ct. at p. 1865.)

Star-Kist, 719 P.2d at 1001.

[3] While it is true that foreign subsidiary dividends are in the preapportioned net income base of corporations doing business in Iowa and domestic subsidiary dividends are not

(Continued on following page)

for assuming that a unitary business engaged in foreign commerce is taxed more harshly than is one engaged in interstate commerce. If every state adopted the Iowa unitary taxation method, the unitary earnings of domestic subsidiaries would be subject to state and United States taxation which could be more burdensome than the taxation of the foreign subsidiary earnings. This possibility negates any claim that the Iowa tax system discourages investment abroad and protects that in the United States.

B. Iowa Tax Treatment Of Subsidiary Dividends Is Justified By Valid Factors Not Related To Economic Protectionism.

In *New Energy Company of Indiana v. Limbach*, 486 U.S. 269, 274 (1988), the Supreme Court stated:

> Thus, state statutes that clearly discriminate against interstate commerce are routinely struck down . . . unless the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism. . . .

(Continued from previous page)

part of such tax base, a domestic subsidiary's earnings are taxed by the United States Government and the forty-six states and the District of Columbia which impose taxes on net incomes. J. Hellerstein, *State Taxation: Corporate Income and Franchise Taxes* ¶1.6, at 20-21(1983). A domestic subsidiary's earnings will be subject to state income tax, whereas if the subsidiary is incorporated abroad, such income may not be subject to state tax. The Iowa tax system does not discourage the incorporation of foreign subsidiaries to conduct business outside of the United States. And, in light of the tax credit that Kraft received on its federal taxes with respect to foreign subsidiary dividends, there is no logical reason why Iowa also has to grant such a tax credit. *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 191 n. 30 (1983).

The difference in Iowa's treatment of foreign subsidiary dividends and of domestic subsidiary dividends is a byproduct of Iowa's decision in Iowa Code § 422.35 to use the taxable income figure reported on the federal income tax return as the starting point for computation of net income for Iowa income tax purposes. *See* Iowa Code § 422.35 (App. 32a, Petition for Writ of Certiorari). Using the federal taxable income figure allows the taxpayer "to merely lift the figures off the federal return and transfer them to the Iowa [income] tax return. The Department of Revenue receives the benefit of the regulations and interpretations of the federal agency." *First National Bank of Ottumwa v. Bair*, 252 N.W.2d 723, 726 (Iowa 1977). The use of the federal taxable income figure avoids carrying out "complex procedures in computing the Iowa tax, involving the time and expense required to complete federal returns" by taxpayers. *Id.* The coupling of Iowa net income in § 422.35 with federal taxable income "is done for the convenience of the taxpayer, as a savings to the State, and to provide the State with a means of verifying the accuracy and honesty of a taxpayer's return." *Getty Oil Co. v. Taxation & Rev. Dept.*, 93 N.M. 589, 592, 603 P.2d 328, 331 (Ct. App. 1979).

Iowa's use of federal taxable income benefits taxpayers, and the State benefits in the administration of the corporate income tax by taking advantage of the federal administration of the federal income tax system as well as the taxable income concept in the Internal Revenue Code. The State accepts Internal Revenue Code exemptions and deductions, even when it means less tax will be paid to Iowa. The State has not adopted the federal taxable income concept in order to be protectionist. Iowa does

not grant a tax break for unitary business activities performed in Iowa. Thus, because the Iowa tax structure is "justified by a valid factor unrelated to economic protectionism," it does not violate the Commerce Clause. *New Energy Company*, 486 U.S. 269, 274 (1988).

II. IOWA'S TREATMENT OF DIVIDENDS DOES NOT DENY PETITIONER EQUAL PROTECTION BECAUSE IT IS RATIONALLY RELATED TO LEGITIMATE STATE PURPOSES.

Kraft's equal protection analysis is in two parts. First, Kraft erroneously states that no legitimate purpose is served by Iowa's coupling of a net income base to the federal net income base. Second, Kraft concedes that such legitimate purpose may exist, but erroneously states that Iowa has deviated so much from federal conformity that a legitimate purpose can no longer be found.

This Court has articulated various fundamental principles that govern constitutional challenges under the Equal Protection Clause. Where, as here, the challenged tax classification does not adversely affect a fundamental interest and is not based on a suspect criterion, it is only tested under the lenient standard of rationality that is traditionally applied in evaluating equal protection challenges to regulation of economic and commercial matters. *Exxon Corporation v. Eagerton*, 462 U.S. 176, 195 (1983). Under this standard, a statute will be upheld if the legislature could have reasonably found "that the challenged classification would promote a legitimate state purpose." *Id.* Broad discretion exists in creating tax classifications. *Leathers v. Medlock*, 111 S.Ct. 1438, 1446 (1991); *Madden v. Kentucky*, 309 U.S. 83, 87-88 (1940). One who attacks a

legislative classification must "negative every conceivable basis which might support it." *Madden*, 309 U.S. at 88.

A. Legitimate State Purposes Are Served.

The federal government has opted to include dividends declared by foreign corporations in the domestic corporate parent's tax base and to provide a tax credit to alleviate dual taxation by the foreign and federal governments and, also, to encourage domestic corporations' foreign business. *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7, 9 (1932). This federal policy is not prompted by constitutional concerns, because dual or double taxation is not forbidden. *F. T. Smith Lumber Co. v. Arkansas*, 251 U.S. 532, 533 (1920). The federal government decided to grant domestic corporations a deduction for dividends paid by other domestic corporations who are subject to federal income taxation. That identical deduction was not available to individual shareholders even though such individuals could claim a tax credit with respect to their receipt of foreign corporate dividends. There is no suggestion by Kraft that the federal treatment of dividends to individual shareholders somehow violated equal protection under the Fifth Amendment.

Whether Iowa's coupling of its tax base to federal taxable income lacks a focus on dual taxation is no basis to assert that such coupling does not serve legitimate state purposes. (Kraft Pet. at 18-19). The Iowa Supreme Court properly noted the following legitimate state purposes served by that coupling:

> The coupling of Iowa net income with the federal formula is convenient for the taxpayer, prevents the taxpayer from spending time and money on complex forms, provides a saving to the state, allows the state to rely on federal regulation and interpretation, and provides the state with an inexpensive and quick way of verifying the accuracy of taxpayers' returns.[4]

Contrary to Kraft's contention, the avoidance of administrative difficulties and of expenses that taxpayers and tax administrators would otherwise experience can be legitimate state purposes.[5] *Madden*, 309 U.S. at 86-90; *Carmichael v. Southern Coal & Coke Co.*, 301 U.S. 495, 511

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[4] "The outstanding characteristic of State corporate net income measures is their broad conformity to the measure of the Federal corporation income tax." J. Hellerstein, *State Taxation: Corporate Income and Franchise Taxes* ¶7.2, at 266 (1983).

[5] Kraft states that these considerations can never be used as a justification for a coupling result that would have the effect of taxing interest and dividends from federal securities in light of the doctrine of intergovernmental immunity. (Kraft Pet. at 21, n. 14). But, this Court has held that when the issue is intergovernmental immunity, "it is inappropriate to rely solely on the mode of analysis developed in our equal protection cases." *Davis v. Michigan Department of Treasury*, 489 U.S. 803, 816 (1989). Kraft also states that Iowa could not tax Illinois corporations solely on the basis of income calculated under Illinois law. (Kraft Pet. at 20-21). But, it is obvious that if Iowa based its tax on the Illinois tax law solely for Illinois corporations, it would be engaged in the very "invidious discrimination, the wholly arbitrary act" which violates equal protection guarantees. *New Orleans v. Dukes*, 427 U.S. 297, 303-04 (1976). The Iowa tax system, under attack here, has no analog to such an extreme example posited by Kraft. The federal taxable income concept is based upon statutes and regulations uniformly applicable to all similarly situated corporations.

(1937). Taxation of income of corporations involves complex determinations and calculations of gross income and deductions, as a cursory reading of the Internal Revenue Code and Internal Revenue Service rules would suggest. In addition, the proper accounting principles must be used. Of the array of complicated accounting systems that can be employed, the tax agency must carefully limit the diversity of accounting systems "to ensure as far as possible that similarly situated taxpayers pay the same tax." *Thor Power Tool Co. v. Commissioner of Internal Revenue*, 439 U.S. 522, 544 (1979).

Federal tax treatment of corporate distributions, including dividends, is "a wonderfully complex subject." Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶7.01, at 7-2 (4th ed. 1979). A host of complicated determinations with respect to dividends and corporate distributions exist. *Id.* at ch. 7. By coupling Iowa net income determinations with the federal taxable income concept, Iowa and taxpayers need apply only one set of rules. In addition, acrimony between taxpayers and tax agency as to the make-up of the tax base is significantly reduced in that determinations made at the federal level will not be subject to decision anew nor be in conflict with those at the state level.

States have no real practicable alternative to application, at the state level, of a host of Internal Revenue Code statutes, Internal Revenue Service regulations, and Internal Revenue Service audit results in making the necessary determinations inherent in a calculation of taxable income because "[s]tate tax administrators have neither large enough staffs nor sufficient expertise to perform full-scale independent audits of the books and records of

large corporations." J. Hellerstein, *State Taxation: Corporate Income and Franchise Taxes* ¶7.2[5], at 275 (1983). Iowa's tax treatment of dividends is clearly consistent with the legitimate purposes advanced by the Iowa Supreme Court. Kraft cannot negative all conceivable bases in support of the Iowa tax system. The fact that overall federal tax policy, as respects the foreign tax credit, differs from the Iowa tax policy does not detract from the legitimacy of the latter.

B. Iowa's Specific Adjustments To Federal Taxable Income Are Not Inconsistent With The Legitimate Purposes Of Federal Conformity.

Kraft points to nine adjustments in Iowa Code sec. 422.35 (1983) that it claims undermine the legitimate state purposes found by the Iowa Supreme Court to be inherent in Iowa's federal taxable income conformity. (Kraft Pet. at 21-22). Kraft's position lacks merit. There is no rigid rule that requires a state to adopt, without modification, the entire federal tax system.[6] As Professor Hellerstein observes, "[t]he most efficient and simplest method of achieving Federal conformity, without complete piggybacking, is to incorporate by reference in the State statute the current key Federal income tax terms, such as 'gross income' and 'taxable income' and then make such specific adjustments as State policy may dictate." J. Hellerstein,

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[6] Merely because Congress has elected a policy with respect to income at the federal level does not "mandate identical treatment by the States." *Mobil Oil Corp. v. Commissioner*, 445 U.S. 425, 448 (1980).

supra p. 22, ¶7.2[1], at 267. Iowa has adopted this approach. *Id.* at 267 n. 19.

Under the logic of Kraft's reasoning, there can never be justification for coupling of state taxable income to federal taxable income to accomplish a legitimate state purpose if the state has enacted a few adjustments to the federal taxation income concept. Kraft does not cite to any authority in support of its novel and unjustified position. Neither the qualitative nor the quantitative nature of Iowa's adjustments require a Court to reject the overall coupling results (or any part of them) on the grounds that they somehow are no longer rationally related to otherwise legitimate state purposes. Within the context of the Iowa law that provides for very few adjustments to federal taxable income in comparison to the multitude of coupling determinations and calculations, it is absurd to suggest that the Iowa tax system has only a remote relationship to federal taxable income. Kraft has not negated the legitimate state purposes that inure to taxpayers and to Iowa as a result of Iowa's incorporation of massive and complex determinations and calculations, including those involving dividends, at the federal level into its income tax system.

Kraft's contention runs afoul of this Court's pronouncement that consistent with equal protection, the legislature may partially, rather than wholly, eliminate all sources of a problem. *Minnesota v. Clover Leaf Creamery Company*, 449 U.S. 456, 466 (1981). Iowa's method and extent of conforming the tax base to federal taxable income are consistent with the legitimate state purposes enumerated by the Iowa Supreme Court.

CONCLUSION

For the above-stated reasons, the Department respectfully requests that the Petition for a Writ of Certiorari be denied.

Respectfully submitted,

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No. 90-1918

IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

KRAFT GENERAL FOODS, INC.,
(Formerly Kraft, Inc.),
Petitioner,

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE,
Respondent.

On Petition For Writ Of Certiorari To The Supreme Court Of Iowa

PETITIONER'S REPLY TO BRIEF IN OPPOSITION

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

NO. 90 - 1918

KRAFT GENERAL FOODS, INC.
(formerly KRAFT, INC.),
Petitioner,

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE,
Respondent.

On Petition for Writ of Certiorari to the Supreme Court of Iowa

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PETITIONER'S REPLY TO BRIEF IN OPPOSITION

I. Respondent's Inability to Find a "Local Benefit" Does Not Negate Iowa's Impermissible Discrimination Against Foreign Commerce.

In undertaking to defend the Iowa Supreme Court's conclusion that a "local benefit" test is the correct test to be applied in determining impermissible discrimination against foreign commerce, respondent devotes almost all of its energies to establishing that there is no local benefit produced under the Iowa taxing scheme. As respondent puts it, "[t]he Iowa tax-

structure does not encourage, protect or otherwise advantage instate activities at the expense of out-of-state activities." (Resp. Br. Op. 7)

Significantly, however, the court below expressed genuine uncertainty as to whether it was applying the proper standard—". . . Supreme Court decisions are unclear whether such a local bias must be found when discrimination against foreign commerce is alleged. . . ." (Pet. App. 7a) It is no surprise, therefore, that respondent is unable to cite a single case in support of its assertion that a finding of purely local bias is necessary to establish impermissible discrimination under the Foreign Commerce Clause. The only cases respondent does cite (*Bacchus Imports, Ltd.* v. *Dias*, 468 U.S. 263 (1984), and *Boston Stock Exchange* v. *State Tax Commission*, 429 U.S. 318 (1977), at Resp. Br. Op. 6) involved discrimination against interstate commerce, not foreign commerce. Respondent's attempt to distinguish *Cook* v. *Commonwealth of Pennsylvania*, 97 U.S. 566 (1878), completely ignores the fact that this Court did not require a finding of purely local bias before striking down the Pennsylvania tax on foreign goods sold at auction.

The one citation offered by respondent that might appear supportive of the test applied by the court below is a 1986 article appearing in the Vanderbilt Law Review. However, the passage quoted by respondent (Resp. Br. Op. 11), which was also quoted by the court below, actually addresses a tax that discriminates against interstate commerce *in favor of foreign commerce*.[1] The commentators express quite

[1] Such a tax was precisely the type of tax considered in *Zee Toys, Inc.* v. *County of Los Angeles* and *Star-Kist Foods, Inc.* v. *County of Los Angeles*, both cited in petitioner's Petition for Certiorari (Pet. 16). In those cases, the Supreme Court of California reached a conclusion contrary to that advocated by the commentators, holding that the statute in question was unconstitutional even though there was no showing of local benefit.

a different view of the situation presented by a case such as the instant case, *i.e.*, where the statute discriminates *against foreign commerce* in favor of interstate commerce.

> It is also unclear whether a state tax provision can favor interstate commerce over foreign commerce. The additional protection afforded foreign commerce renders it unlikely that such a provision would be held constitutional.

Tatarowicz and Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 Vand. L. Rev. 879, 941 n.298 (1986).

The flaw in the Iowa Supreme Court's reasoning is that it believed it was required to find an advantage peculiar to local business, when a benefit to domestic commerce over foreign commerce is all that should be required. Even respondent seems to recognize that insisting upon an exclusively local benefit to establish impermissible discrimination cannot be reconciled with this Court's decision in *Cook* v. *Pennsylvania*. As a result, respondent seems to be suggesting that an instate benefit need only be *among* the benefits identified, rather than the *exclusive* benefit enjoyed.

But if an instate benefit need only be among the benefits identified, respondent should agree with petitioner that the Iowa taxing scheme is unconstitutional on its face. It is undeniable that under Iowa law, domestic subsidiaries, whether doing business in

Iowa ("Iowa businesses") or elsewhere, enjoy an advantage over foreign subsidiaries doing business abroad because dividends paid by the former are excluded from their parents' Iowa tax base while dividends paid by the latter are included. As a result, to achieve the same net funding level for the parent, a domestic subsidiary can pay a lesser amount of dividends than a foreign subsidiary. That in turn leaves the domestic subsidiary with more funds available for its own operations. The fact that such an advantage is afforded to Iowa businesses (in addition to other domestic businesses) should be all the local benefit necessary to establish discrimination against foreign commerce under respondent's local benefit test. Even under respondent's reading, *Cook* v. *Pennsylvania* supports that conclusion.

Respondent seeks to avoid the trap it has thus set for itself by pointing to the fact that Iowa also taxes an appropriate portion of the earnings of all subsidiaries doing business in Iowa. Respondent claims that the Iowa tax on such earnings should be viewed as neutralizing any benefit that is derived from the exclusion allowed for dividends paid by such subsidiaries. (Respondent even goes so far as to note that the earnings of subsidiaries located in most (though not all) other states are also subject to separate corporate income tax.)

Whether a subsidiary's earnings are subject to state income tax should not be relevant to the discrimination issue here presented. A tax on subsidiary earnings is quite different from a tax on the parent's receipt of subsidiary dividends. See *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159, 191 n.30 (1983). Moreover, if a tax on subsidiary earnings is

relevant to the inquiry, it must be recognized that the earnings of foreign subsidiaries may be subject to tax at both federal and local levels in the countries in which they operate. In addition, foreign subsidiary dividends may also be subject to yet another tax—a withholding tax imposed by the country from which the dividends are remitted, as was in fact the case here. (Pet. App. 53a.) There is thus no merit in respondent's suggestion that because of a domestic subsidiary's own income tax exposure, domestic subsidiary dividends do not enjoy an advantage over foreign subsidiary dividends when remitted to corporations doing business in Iowa.

The need for guidance by this Court on the discrimination issue here presented has become even more acute in the short time since petitioner's Petition for Certiorari was filed. In *Dart Industries* v. *Clark*, A.A. No. 87-2 (R.I. Dist. Ct. Sixth Div., June 19, 1991), a state district court (Moore, J.) upheld the constitutionality of a Rhode Island taxing statute which, like the Iowa statute, includes foreign subsidiary dividends but excludes domestic subsidiary dividends in computing the corporate income tax base. The court concluded that the Rhode Island statute did not violate the discrimination prong of the *Complete Auto* test because "all domestic corporations with foreign subsidiaries are treated the same." Slip op. at 5. (Copies of the unpublished opinion of the Rhode Island District Court have been furnished to respondent and lodged with the Clerk of this Court.)

The opinion of the Rhode Island court reflects a total misunderstanding of the discrimination issue presented. The question is whether dividends paid by foreign subsidiaries bear an impermissible burden rel-

ative to dividends paid by domestic subsidiaries, thereby adversely impacting their respective parent companies that are competing in Iowa and inappropriately influencing how those companies may choose to structure their business operations.

The Rhode Island decision underscores the necessity for this Court to articulate the correct test to be applied in cases involving a claim of impermissible discrimination under the Foreign Commerce Clause. To allow the decision below to stand without further review will perpetuate the uncertainty that now exists with respect to this fundamental constitutional question.

II. Convenience Alone Does Not Justify Iowa's Classification of Dividend Income.

Respondent contends that "taxpayer and administrative convenience" is a legitimate purpose for Iowa's taxation of corporations receiving foreign subsidiary dividends on a more onerous basis than corporations receiving domestic subsidiary dividends. In support of its position, respondent cites two cases in which this Court accepted administrative convenience as an appropriate justification for a state's differentiation in the treatment of certain taxpayers. *Carmichael* v. *Southern Coal Co.*, 301 U.S. 495, 511 (1937) (administrative convenience and expense in the collection or measurement of tax may justify differentiation in the treatment of small taxpayers; expense and inconvenience of collecting tax may be disproportionate to revenue obtained); *Madden* v. *Kentucky*, 309 U.S. 83, 87-90 (1940) (higher ad valorem tax on bank deposits of residents placed outside the state than on bank deposits placed within the state held justifiable where "[t]he treatment accorded the two

kinds of deposits may have resulted from the differences in the difficulties and expenses of tax collection").

As is clear from the foregoing, the different groups of taxpayers involved in the cases cited by respondent were not "similarly situated." Differences in their circumstances (small incomes v. large incomes; out-of-state depositors v. in-state depositors) justified the differences in tax treatment afforded, even where those differences were motivated by considerations of convenience in tax administration. Respondent fails to cite any authority recognizing administrative convenience as a justification for discrimination with respect to taxpayers that *are* similarly situated, such as corporations doing business in Iowa that have no differences in their own circumstances but simply receive their dividends from different sources.

Moreover, respondent concedes that if, for purposes of convenience, Iowa were to subject an Illinois corporation doing business in Iowa to tax based on its net income as calculated for Illinois tax purposes, Iowa would be engaged in a "wholly arbitrary act" that violates the Equal Protection Clause. (Resp. Br. Op. 20 n.5) Thus, respondent asserts that the convenience of using numbers from another return *would not* be sufficient justification for taxing all the income of certain corporations (those from Illinois) differently than all the income of other corporations (those from elsewhere). Yet, respondent also asserts that such convenience *would* be sufficient justification for taxing the dividend income of certain corporations (those with domestic subsidiaries) differently than the dividend income of other corporations (those with foreign subsidiaries). To draw a distinction between domestic and

foreign dividend income merely because it is convenient to do so, and to tax one class but not the other, is to act in the "wholly arbitrary" manner that respondent concedes is unconstitutional.

The values implicated by the Equal Protection Clause would be totally undermined if the "taxpayer and administrative convenience" that may come from using federal numbers were allowed to justify excluding one category of dividend income while including the other when received by similarly situated taxpayers. To hold otherwise would completely eviscerate the meaning of "equal protection" in this context.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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No. 90-1918

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OCTOBER TERM, 1991

KRAFT GENERAL FOODS, INC.
(FORMERLY KRAFT, INC.), PETITIONER

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF IOWA

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION PRESENTED

Whether Iowa discriminates against foreign commerce, in violation of the Commerce Clause or the Equal Protection Clause of the Constitution of the United States, by imposing its annual tax on the apportioned "net income" of corporations doing business in the State and by defining "net income" for this purpose to mean "the taxable income * * * as properly computed for federal income tax purposes under the Internal Revenue Code" (Iowa Code Ann. § 422.35 (West 1990)).

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In the Supreme Court of the United States

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KRAFT GENERAL FOODS, INC.
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IOWA DEPARTMENT OF REVENUE AND FINANCE

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF IOWA

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

This brief is submitted in response to the Court's order inviting the Solicitor General to express the views of the United States.

OPINION BELOW

The opinion of the Supreme Court of Iowa (Pet. App. 1a-10a) and its order denying rehearing (Pet. App. 57a) are reported at 465 N.W. 2d 664. The opinion of the district court (Pet. App. 11a-23a) is unreported. The order of the Iowa Department of Revenue and Finance (Pet. App. 24a-27a) (based upon a Stipulation of Facts (Pet. App. 28a-56a) adopted as the findings of the Director (Pet. App. 26a)) is unreported.

JURISDICTION

The judgment of the Supreme Court of Iowa was entered on February 20, 1991. A petition for rehearing was denied on March 19, 1991 (Pet. App. 57a). The petition for a writ of certiorari was filed on June 14, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. 1257(a).

STATEMENT

1. Petitioner is a Delaware corporation with its principal place of business in Illinois.[1] Petitioner conducts a unitary business throughout the United States and, through its foreign subsidiaries, in certain foreign countries (Pet. App. 28a-29a, 33a). Petitioner is qualified to, and does, conduct business in Iowa.

On June 3, 1985, the Director of Revenue of the State of Iowa issued a notice of assessment to petitioner for taxes, interest and fees due for 1981 in the aggregate amount of $51,756.62 (Pet. App. 32a-33a). The assessment was made under Section 422.33 of the Iowa Code, which imposes an annual tax on the apportioned "net income" of corporations doing business in the State (Pet. App. 3a, 58a). Section 422.35 of the Iowa Code (Pet. App. 62a), with adjustments not at issue here, defines the term "net income" as "taxable income * * * as properly computed for federal income tax purposes under the Internal Revenue Code of 1954." The Iowa Code thus incorporates federal standards for determining "taxable income" in deriving taxable "net income" for state purposes.

[1] Petitioner is the successor by merger of Kraft, Inc., also a Delaware corporation that during the calendar year 1981 had its principal office and commercial domicile in Illinois and was qualified to do business in Iowa. References in this brief to "petitioner" are either to the corporation active at the time described or to both corporations.

Under the Internal Revenue Code, dividends received by a corporation are included within its "gross income." 26 U.S.C. 61(a)(7). In computing "taxable income," however, a corporation may deduct 70% (formerly 85%) of the dividends it receives from another *domestic* corporation and may deduct 100% of the dividends it receives from a *domestic* corporation that it controls by ownership of at least 80% of its stock. 26 U.S.C. 243.[2] Dividends received from a *foreign* corporation or subsidiary, however, are *not* deducted in determining the "taxable income" of a corporation under the Internal Revenue Code. Instead, the Code provides an election to the corporate taxpayer either to deduct the foreign income taxes that it has paid on its own foreign operations (26 U.S.C. 164(a)(3); see note 3, *infra*) or instead to take a tax credit based on the amount of foreign income taxes it paid and on the amount of foreign income taxes paid by the foreign corporation that paid dividends to the taxpayer (26 U.S.C. 901, 902).

As a result, when a corporate taxpayer receives dividends, whether from domestic or from foreign corporations, the Internal Revenue Code requires that the amount of those dividends be included in gross income, but then, in computing "taxable income", allows a deduction of 70% or 100%, as the case may be, of the amount of dividends from taxable domestic corporations. In basing its corporate income tax upon an apportioned fraction of "net income", defined as "the taxable income * * * as properly computed for

[2] "Domestic corporations" are defined as corporations organized under the law of the United States or any State. 26 U.S.C. 7701(a)(4).

federal income tax purposes," Iowa to that extent accepts and follows the federal pattern.

During 1981, petitioner owned more than 80% of the stock of several corporations organized and conducting their respective segments of petitioner's unitary business exclusively outside the United States. Six of these foreign subsidiaries paid dividends in that year in the aggregate amount of $10,181,815, of which, after foreign income taxes were withheld, petitioner received $8,690,928 (Pet. App. 52a-53a).[3] In computing "net income" on its Iowa corporate income tax returns for 1981, petitioner deducted from its reported federal "taxable income" the dividends it had received from its foreign subsidiaries (*id.* at 32a). The deficiency assessed by the Director of Revenue of the State of Iowa required these foreign dividends to be included in petitioner's "net income" because such dividends could not properly be deducted in computing "taxable income" under the Internal Revenue Code (*id.* at 32a-33a).

Petitioner protested the asserted deficiency of the Iowa State Department of Revenue and Finance. Petitioner asserted that inclusion of the dividends it received from foreign subsidiaries in its net income discriminated against foreign commerce, in violation of the Commerce Clause (Art. I, § 8, Cl. 3), and

[3] The petition does not disclose what fraction of petitioner's net income is apportioned to, and taxed by, Iowa. The stipulated facts also do not reveal whether petitioner itself engaged in business beyond, as well as within, the United States. In conformity with Rule 29.1 of the Rules of this Court, petitioner lists 87 subsidiaries other than wholly owned subsidiaries (Pet. App. 76a-79a). The names of the 87 suggest that most, if not all, are foreign corporations. The list does not include the six subsidiaries (identified at Pet. App. 52a-53a) whose dividends are at issue in this case.

denied petitioner the equal protection of the laws, in violation of the Fourteenth Amendment to the Constitution of the United States. The Director of Revenue and Finance denied the protest, noting that he had no authority to decide the constitutionality of the State's laws (Pet. App. 24a-27a).

2. The District Court of Polk County, acting on the basis of a stipulated record (Pet. App. 28a-56a), upheld the assessment issued by the Director of Revenue and Finance (*id.* at 11a-23a). The court held that "Kraft has not shown that the Iowa tax in any way benefited local in-state industry in detriment to out-of-state industry" (*id.* at 16a) and "has not shown that the Iowa tax exerts a pressure on interstate business to conduct more of its activities in Iowa" (*id.* at 17a). The court characterized as "wholly speculative" the argument that, if other States followed the Iowa pattern, "it would be a 'powerful persuader' to locate foreign operations within U.S. borders" (*ibid.*). The court therefore rejected (*id.* at 22a-23a) petitioner's equal protection and Commerce Clause claims.

3. The Supreme Court of Iowa affirmed (Pet. App. 1a-10a). In response to petitioner's charge that the Iowa corporate income tax discriminated against foreign commerce, the court stated that "the question is whether Iowa businesses are benefited at the expense of foreign businesses" (*id.* at 7a) and concluded that "[b]ecause the Iowa tax does not differentiate between in-state or out-of-state taxpayers, no impermissible discrimination exists" (*id.* at 7a-8a). The court also rejected petitioner's equal protection claim, noting (*id.* at 9a) that no suspect classification or fundamental right was at issue in this case and that use of the federal concept of "taxable

income" served legitimate state purposes (as well as the convenience of taxpayers) in promoting economy of effort, convenience, and administrative efficiency (*id.* at 9a-10a).

DISCUSSION

1. The facts of this case parallel those of *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425 (1980), in which this Court upheld application of Vermont's corporate income tax to dividends received by a domestic corporation from foreign subsidiaries and affiliates. As petitioner acknowledges, Vermont's corporate income tax operates "in identical fashion with Iowa" (Pet. 7). In the *Mobil* case, this Court rejected the claim that, by taxing dividends received from foreign subsidiaries of a unitary business,[4] the Vermont statute unconstitutionally burdened foreign commerce. 445 U.S. at 446-449. The Court concluded that "the source of the income" (*id.* at 438) was not material in determining the State's power to tax. *Ibid.*

The claim in the present case differs from *Mobil* only in two respects: (i) the taxpayer now concedes (as it must) that the State has *power* to tax dividends received from foreign affiliates; and (ii) the taxpayer now claims instead that the *manner* in which the tax is imposed results in an unconstitutional discrimination against foreign-derived dividend income. That the two cases differ only to this limited extent

[4] A "unitary" business is one whose operations are sufficiently integrated on a regional, national or international scale that it is proper, for tax purposes, to apportion the income of the entire business unit among the states or regions affected. See *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. at 432, 437.

does not deny to petitioner's argument whatever intrinsic merit it may possess. It does, however, suggest that the "facial" constitutional flaw now urged by petitioner (Pet. 9) was not sufficiently apparent to provoke consideration by Court or counsel in the *Mobil* case.

2. a. In defining "taxable income" for corporations, the Internal Revenue Code differentiates in its treatment of dividends received from domestic corporations and foreign corporations. See pp. 3-4, *supra*. Dividends that a corporation receives from another domestic corporation are excludable (in part or in whole) from the "taxable income" of the recipient; dividends that a corporation receives from a foreign corporation are not excludable. See *ibid.*[5] The reason for this different treatment is that the income of a domestic corporation has already been subjected to a federal tax before it pays dividends, but the income of a foreign corporation has not.[6] By providing for

[5] As this Court pointed out in *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159, 184-185, 187 (1983), the United States (as well as most States and foreign governments) ordinarily treats separate corporations, even if closely related, as independent entities for purposes of taxation. There are some special and limited exceptions, such as foreign personal holding companies (Sections 551-558) and so-called "Subpart F" income of controlled foreign corporations (Sections 951-965), that receive special treatment. See *Eder* v. *Commissioner*, 138 F.2d 27 (2d Cir. 1943) and *Garlock, Inc.* v. *Commissioner*, 489 F.2d 197 (2d Cir. 1973), cert. denied, 417 U.S. 911 (1974).

[6] Section 23(p) of the Revenue Act of 1932, ch. 209, 47 Stat. 182, made sure that the deduction was available only if the dividend-paying corporation was "taxable under this title." See H.R. Rep. No. 708, 72d Cong., 1st Sess. 12 (1932); S. Rep. No. 665, 72d Cong., 1st Sess. 16 (1932)

special treatment of dividends received by one domestic corporation from another, the federal scheme avoids a "double tax" on the corporate income stream. See 3 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 90.2.3, at 90-16 (1981) (the statute avoids the "multiple taxation of corporate earnings as they passed from one corporation to another, possibly within the same chain of beneficial ownership").[7]

After federal "taxable income" has been computed under these rules, a credit is allowable under the Internal Revenue Code against the tax due on the foreign dividends received by a corporation. The credit is based on the amount of foreign income taxes that the foreign corporation has paid on the income from which its dividends were distributed. See 26 U.S.C. 901, 902. Because of differences in foreign and domestic tax rates, this credit does not necessarily (or even often) result in identical tax treatment of the income stream of domestic and foreign subsidiaries of a United States corporation. Cf. *United States* v. *Goodyear Tire & Rubber Co.*, 493 U.S. 132 (1989). The resulting differences in the tax treatment of domestic and foreign entities is the unavoidable product of practical international realities. It has never been suggested to effect an improper discrimination

[7] For dividends received from foreign corporations, the situation is entirely different. The earnings of foreign corporations not doing business in the United States have not been subjected to tax in the United States; they become subject to taxation in the United States only when paid as dividends to United States taxpayers. There is differentiation, but not discrimination, in (i) taxing domestic corporate earnings at the initial level but not when distributed to another corporate entity, and (ii) *not* taxing foreign earnings at the initial level but subjecting them to tax when paid as dividends to United States taxpayers.

between domestic and foreign source income at the federal level. See note 7, *supra*.

b. Iowa accepts the result produced by the federal "taxable income" definition for corporate dividend income. Iowa does not, however, follow the federal practice of allowing a credit for foreign taxes paid against the foreign dividends received by a unitary domestic corporate enterprise.[8] The Iowa scheme thus effects a greater differentiation in the treatment afforded to foreign and domestic dividend income than results under the Internal Revenue Code.

The degree or amount of the difference between the actual tax burden imposed on domestic and foreign source income under the Iowa scheme, however, is not addressed in the record of this case. While the Iowa scheme, like the federal scheme, "facially" (Pet. 9) differentiates between the two types of dividends, that does not necessarily imply that the total income stream of a foreign subsidiary is subjected by Iowa to a greater or lesser total tax burden than that of a domestic subsidiary of the same unitary enterprise.[9]

[8] In *Mobil Oil Corp.* v. *Commissioner of Taxes*, the Court observed that, "[a]bsent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States." 445 U.S. at 448.

[9] The factual variations are almost limitless. See Br. in Opp. 8-11. If the dividends from domestic corporations that are excluded from petitioner's net income under the federal and Iowa rules are paid from income that is taxed by Iowa and other States on an apportioned basis, the tax burden on domestic corporate income may well *exceed* that of the burden on foreign source income under the Iowa tax scheme. There is also no evidence in this case of the treatment afforded by foreign national and local governments to similar items of income. In this context, petitioner's assertion of a "facial"

There is thus no inescapable logic to petitioner's claim that a "facial" difference in treatment by Iowa necessarily results in a greater tax burden on foreign source income. It may, or it may not. See notes 7, 9, *supra*. There is, similarly, no inescapable logic to petitioner's claim that a "facial" difference in treatment by Iowa *necessarily* discriminates against foreign commerce. Here, as in *Container Corp.* v. *Franchise Tax Board*, whether "the combination of the [state, national and foreign] methods" of taxation results in the same income being taxed more heavily when earned by a foreign or domestic subsidiary "is dependent solely on the facts of the individual case" (463 U.S. at 188).[10]

In this case, petitioner elected—presumably for sound tactical reasons—to present its case on a theory of "facial" rather than "actual" discrimination. That election deprives the Court of any ability to assess (i) the degree (or even the existence) of any burden that the Iowa scheme may systematically impose on foreign commerce and (ii) the degree (or even the existence) of any systematic preference that may result to domestic commerce under the Iowa scheme. Since the record of this case does not provide a suitable factual context for evaluation of the claimed con-

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discrimination against foreign commerce is, as the lower courts held, entirely "speculative" (Pet. App. 17a).

[10] In *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. at 446-449, this Court disposed of the suggestion that application of the State's apportioned income tax to foreign dividend income received by a unitary corporate enterprise runs afoul of the principles articulated in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979). Petitioner's invocation of *Japan Line* (Pet. 12-15) adds nothing to the argument that the Court rejected in the *Mobil* case.

stitutional issues, and since there is no conflict in the decisions of state or federal courts on the specific question actually presented in this case, further review is not warranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

KRAFT GENERAL FOODS, INC.
(formerly Kraft, Inc.),
Petitioner,

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE,
Respondent.

On Petition for Writ of Certiorari to the Supreme Court of Iowa

---

BRIEF OF THE COMMITTEE ON STATE TAXATION OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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BRIEF OF THE COMMITTEE ON STATE TAXATION OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE AS *AMICUS CURIE* IN SUPPORT OF PETITIONER

INTRODUCTORY STATEMENT

This brief is submitted by the Committee on State Taxation of the Council of State Chambers of Commerce as amicus curiae in support of petitioner in the above-captioned case. Written consents of the Petitioner and the Respondent have been obtained and have been filed with this Court.

INTEREST OF *AMICUS CURIAE*

The Council of State Chambers of Commerce (Council), organized in 1932, consists of 43 state chambers of commerce. The Committee on State Taxation (COST), an advisory committee of the Council, consists of 357 cor-

porate members, engaged in interstate and international business. COST's objective is to preserve and promote equitable and non-discriminatory state and local taxation of multijurisdictional business entities.

The Iowa tax system discriminatorily imposes a tax on dividends received from corporations incorporated and doing business in a foreign country while exempting the dividends received from corporations incorporated under the laws of one of the United States. Similar tax schemes are imposed in other states.

The majority of COST member companies are engaged in business in jurisdictions outside the United States through foreign subsidiaries. Thus, COST has a great interest in the present case, which challenges the imposition of a discriminatory tax on corporations doing business in foreign countries in violation of the foreign commerce clause.

SUMMARY OF ARGUMENT

Under the Iowa tax scheme, dividends from domestic subsidiaries (corporations incorporated under the laws of Iowa or any other of the United States) are excluded from the tax base, in whole or in part, but dividends received from foreign subsidiaries (corporations incorporated under the laws of a non-United States jurisdiction and doing business in non-U.S. jurisdictions) are included in the tax base. In other words, the State has given preferential treatment to domestic commerce over foreign commerce. The Iowa Supreme Court, in analyzing whether this tax scheme violated the foreign commerce clause, applied the incorrect test. In determining whether Iowa's taxation of foreign subsidiary dividends discriminated against foreign commerce, the court did not compare the treatment of foreign commerce with domestic commerce. Rather, the court incorrectly compared foreign commerce with intrastate commerce.

This Court has not had an opportunity to determine whether impermissible discrimination exists in the context of a foreign commerce clause challenge since the modern trend of commerce clause analysis has been developed. However, it is clear that in determining whether a tax discriminates against foreign commerce the appropriate issue to be resolved is whether the tax discriminates between foreign commerce and commerce within the United States. *Hale v. Bimco*, 306 U.S. 375 (1939); *Cook v. Pennsylvania*, 97 U.S. 566 (1878).

The issue of whether discriminatory state tax treatment of foreign subsidiary dividends violates the foreign commerce clause has wide impact. Ten jurisdictions currently include all or part of the dividends received from foreign subsidiaries in their tax base while excluding dividends received from domestic subsidiaries from the tax base. United States corporations engaged in business in foreign jurisdictions typically do so through foreign subsidiaries. Thus, these companies are subject to the same kind of discrimination as that suffered by Kraft in this case. Hence, the issue in this case has impact beyond the particular taxpayer in this case and the particular taxing jurisdiction involved. Therefore, guidance from this Court is important. It is clearly necessary for this Court to expressly address whether a state's tax preference of interstate commerce over foreign commerce violates the foreign commerce clause.

ARGUMENT

I. THE APPLICATION OF THE NONDISCRIMINATION PRONG OF THE *COMPLETE AUTO* TEST IN THE CONTEXT OF THE FOREIGN COMMERCE CLAUSE HAS NOT BEEN ADDRESSED BY THIS COURT

The issue in this case is whether a State tax that facially discriminates in favor of domestic commerce over foreign commerce violates the dormant foreign commerce clause because it fails to satisfy the nondiscrimination prong of the four-part test set forth in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). This four part test is the initial test to be applied in a foreign commerce clause case. *Wardair Canada Inc. v. Florida Department of Revenue*, 477 U.S. 1, 8 (1986), *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 445-446 (1979). In this case, the discrimination takes the form of the inclusion of foreign subsidiary dividends in the tax base while excluding from the tax base dividends paid by United States subsidiaries.

This Court has not had the opportunity since it decided *Complete Auto* to apply that case's four prong test in a foreign commerce clause context. In the four foreign commerce tax cases decided since *Complete Auto, Wardair, Japan Line, Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983) and *Mobil Oil Corporation v. Commissioner of Taxes of Vermont*, 455 U.S. 425 (1980) this Court had no occassion to discuss the application of the discrimination prong of the *Complete Auto* test, because the parties either conceded the absence of discrimination or did not raise the issue. Thus, no recent cases have considered the application of the nondiscrimination test in the context of foreign, as opposed to interstate, commerce. The Iowa Supreme Court itself noted that the application of the nondiscrimination test in the foreign commerce context is unclear. *Kraft, Inc. v. Iowa Department of Revenue and Finance*, 465 N.W.2d 664 (Iowa 1991).

However, this Court has, in pre-*Complete Auto* decisions, determined that the foreign commerce clause was violated by comparing the treatment of foreign commerce with the treatment of domestic commerce. The decision of the Iowa Supreme Court, which required a showing of an intrastate benefit is clearly inconsistent with the decisions of this Court.

In *Cook v. Pennsylvania*, 97 U.S. 566 (1878), this Court held that a tax scheme which imposed a tax on foreign goods sold at auction and exempted goods of American growth or manufacture violated the foreign commerce clause. This Court did not, in reaching its decision, ask whether Pennsylvania growers or manufacturers were benefited to the exclusion of those from other states. Had it applied a "local benefit" test, as applied by the Iowa Supreme Court, no unconstitutional discrimination would have been found since, like the Iowa statute, all domestic United States commerce is treated equally. Rather, this Court simply looked at whether foreign commerce was disfavored when compared with domestic commerce, stating "[i]f a tax assessed by a State injuriously discriminating against the products of a State of the Union is forbidden by the Constitution, a *similar tax against goods imported from a foreign State is equally forbidden.*" *Id.* at 573 (emphasis added).

In *Hale v. Bimco*, 306 U.S. 375 (1939), this Court addressed the constitutionality, under the foreign commerce clause, of a Florida statute that imposed an inspection fee only on cement from sources outside the United States. As in *Cook*, this Court held that this facial discrimination between foreign commerce and interstate commerce violated the foreign commerce clause.

This Court has never suggested that the four-prong test set forth in *Complete Auto* supersedes or in any way changes the analysis applied in *Cook* and *Hale*. Rather, these cases must be read together with and consistently with *Complete Auto*. Such a reading clearly shows that, in the context of the foreign commerce clause, the dis-

crimination analysis requires a comparison of foreign commerce with domestic commerce. The Iowa Supreme Court failed to apply this analysis, and, therefore, its decision must be reversed.

Further, the Florida Supreme Court has taken a different view from that of the Iowa Supreme Court in *Miller v. Publicker Industries, Inc.*, 457 So.2d 1374 (Fla. 1984), in which it held that a fuel tax exemption for gasohol containing agricultural products grown in the United States facially discriminated against foreign commerce. Thus, there are conflicting decisions in the state courts with regard to the correct standard to be applied and a taxpayer will face different results and disparate treatment depending on the state in which it does business. Review of the decision of the Iowa Supreme Court by this Court is, therefore, necessary to restore uniform application of the foreign commerce clause.

II. THIS ISSUE AFFECTS THE VAST MAJORITY OF MULTISTATE AND MULTINATIONAL CORPORATE TAXPAYERS

The issue in this case affects the large number of corporate taxpayers doing business in foreign jurisdictions through foreign subsidiaries. Further, Iowa is not alone in its facial discrimination against foreign commerce through differing tax treatment of foreign subsidiary dividends than domestic subsidiary dividends.

The states of New Mexico [1], Vermont [2], Oklahoma [3], South Carolina [4] and Rhode Island [5] include foreign subsidiary dividends in their tax base while excluding domestic subsidiary dividends from their tax base. Four

[1] N.M. Stat. Ann. § 7-4-2

[2] Vt. Stat. Ann. § 5811(18)

[3] Okla. Stat. Ann. § 2358(A)(4)(b)

[4] S.C. Code Ann. §§ 12-7-415; 12-7-1120(2)

[5] R.I. Gen. Laws §§ 44-11-11(a); 44-11-12

other states allow a partial exclusion for foreign subsidiary dividends which is less than the exclusion allowed for domestic subsidiary dividends.[6] Thus, corporations face the discriminatory treatment and attendant competitive disadvantage in Iowa and other jurisdictions. Moreover, if the decision of the Iowa Supreme Court is not reversed, other states will undoubtedly consider including foreign subsidiary dividends in their tax bases as a means of increasing tax revenues through the exportation of tax burdens.

According to a survey of COST member companies, eighty-seven percent of the member companies do business in foreign jurisdictions through foreign subsidiaries. Seventy-two percent of the member companies receiving dividends from their foreign subsidiaries are required to file corporate income tax returns in Iowa. Approximately one-half of these companies report doing business in at least one of the other jurisdictions which includes foreign subsidiary dividends in the tax base while excluding all or part of domestic subsidiary dividends.[7]

Clearly, this case presents a question of general importance. The issue affects the validity of taxing schemes in jurisdictions other than Iowa. And, as the above figures show, the issue greatly impacts corporations engaged in multistate and multinational commerce.

It is important to note that corporations engaged in multinational business do so for a number of business reasons, including:

> the requirements of the local country, a better ability to limit their liability in that country, the marketing advantage of being perceived by customers as a local company, greater ease in repatriating funds, greater

[6] Colorado (Colo. Rev. Stat. §§ 39-22-303(10); 39-22-304); Kansas (Kan. Stat. Ann. § 79-32,138(c)(vi); Maine (Me. Rev. Stat. Ann. § 5200-A2.G); and Missouri (Mo. Ann. Stat. § 143.431).

[7] This information is taken from a June 1991 survey of COST member companies.

> ease in borrowing funds locally, and ability to own property and manufacture in that country.

Stipulation of the Parties, ¶ 10, App. 30a. Thus, the tax scheme imposed by Iowa and other states penalizes corporations for doing business in the most advantageous form, thereby foreclosing tax-neutral decisions in violation of the foreign commerce clause. *See, Westinghouse v. Tully*, 466 U.S. 388 (1984); *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318 (1977). The tax schemes imposed by such states affect decisions on where to incorporate and where to invest, encouraging capital investment in domestic over foreign subsidiaries. However, "[f]oreign commerce is preeminently a matter of national concern." *Japan Line*, *supra* at 448. Congress has been given the power to regulate foreign commerce. It is not for state legislatures to either encourage or discourage forms of domestic or foreign commerce through their tax systems.

CONCLUSION

For the foregoing reasons, the Committee on State Taxation of the Council of State Chambers of Commerce respectfully requests that Petitioner's Petition for Writ of Certiorari be granted.

Respectfully submitted,

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Respondent.

On Petition for a Writ of Certiorari To the Supreme Court of Iowa

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SUPPLEMENTAL BRIEF OF PETITIONER

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SUPPLEMENTAL BRIEF OF PETITIONER

Uncharacteristically, the Brief for the United States is in part misleading and in part inaccurate. It also relies upon a curious and unsupported constitutional theory. Its recommendation should therefore be ignored.

The United States makes two main points. First, it suggests that the issue here presented was disregarded by both this Court and counsel in *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425 (1980), because of a presumed lack of merit. Second, under the novel theory it advances, the United States contends that there is insufficient evidence in the record

to determine whether the Iowa taxing scheme impermissibly discriminates against foreign commerce. The United States is wrong on both counts.

I. The Relevance of *Mobil*

A careful reading of *Mobil* reveals that the discrimination issue here presented was *intentionally* not raised there as part of counsel's complex "litigation strategy." See 445 U.S. at 434. The reason is clear. Mobil's "foreign source" dividends came from *two* sources—certain foreign subsidiaries and Arabian American Oil Company (Aramco), a Delaware corporation doing business overseas in which Mobil owned a 10 percent interest. *Id.* at 435, 430 n.5. (Approximately 66 percent of Mobil's dividends in at least one of the years involved came from Aramco. *Id.* at 457 n.10.)[1]

The discrimination argument petitioner raises here would not apply to the taxable portion of dividends received from a *domestic* corporation such as Aramco engaged in business in a foreign country. For that reason, it is understandable why Mobil's counsel did not raise the point here at issue, but chose instead to challenge the Vermont tax on four other constitutional grounds, all of which applied to its Aramco dividends. To suggest, as the United States now does, that the discrimination claim raised here "was not sufficiently apparent to provoke consideration by Court or counsel in the *Mobil* case" (Br. U.S. 7) is not only gratuitous, but totally misleading.

[1] With only a 10 percent interest in Aramco, Mobil enjoyed only an 85 percent deduction for the Aramco dividends it received. See 445 U.S. at 435 n.12.

II. The Novel Theory Advanced by the United States

The United States argues that in order to decide whether there is "discrimination" under the Iowa taxing scheme, this Court must determine not merely how foreign and domestic subsidiary dividends are taxed by Iowa, but how "total income streams" are taxed. (Br. U.S. 9) (A "total income stream" presumably includes both the earnings from which dividends are paid and the dividends themselves.) Iowa's tax treatment of dividends is said to amount merely to facial "differentiation," not facial "discrimination." Such differentiation, the argument goes, "does not necessarily imply that the total income stream of a foreign subsidiary is subjected by Iowa to a greater or lesser total tax burden than that of a domestic subsidiary of the same unitary enterprise." (*Id.*)

The United States bolsters its argument by noting that the earnings of a domestic subsidiary that may be taxed "by Iowa and other States on an apportioned basis" may bear an overall tax burden that exceeds that borne by "foreign source income" under the Iowa scheme. (Br. U.S. 9 n. 9) Finally, the United States asserts that there is "no evidence in this case" of the tax treatment afforded similar items of income by foreign governments. As a result, it argues (quoting the trial court completely out of context) that petitioner's claim of facial discrimination against foreign commerce is "entirely 'speculative'." (*Id.*)

The theory advanced by the United States is surely novel. Petitioner is aware of no case decided by this court that has evaluated a claim of discrimination under one State's taxing scheme (i.e., Iowa's income tax on dividends received by parent companies doing business there) by taking into account not only (1)

the taxing schemes of other jurisdictions (i.e., other States and foreign governments), but also (2) the application of those taxing schemes to income earned by other entities (i.e., the income earned by the dividend-paying subsidiaries).[2]

In fact, this Court's decisions in *Armco Inc.* v. *Hardesty,* 467 U.S. 638 at 644-645 (1984) and *Tyler Pipe Indus. Inc.* v. *Washington Dept. of Revenue,* 483 U.S. 232 at 247 (1987), clearly establish the inappropriateness of any reliance on taxes imposed by other jurisdictions in determing whether a particular tax is facially discriminatory. The theory advanced by the United States is in direct contradiction to the holding of those cases. While both cases involved discrimination against interstate commerce, no decision of this Court indicates that the rule is otherwise when the claim involves discrimination against foreign commerce. If foreign commerce is to receive different treatment, as the United States seems to claim, surely a rule of such magnitude should be declared by this Court.

Even if the tax schemes of other jurisdictions are to be considered, how they apply to *other entities* cannot be relevant. In *Mobil, supra* at 440-441, this

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[2] The United States claims to find some support for its novel theory in the examples provided by respondent in its Brief in Opposition (pp. 8-10). The examples seek to support respondent's position that a claim of discrimination against foreign commerce must be tested by determining whether a benefit or advantage is afforded to local (in-state) commerce (not domestic commerce generally). None of the examples addresses the comparative tax treatment of foreign and domestic "total income streams." Interestingly, the United States clearly disagrees with respondent on the local v. domestic commerce issue. (Br. U.S. 9-10)

Court made it clear that, as a matter of Due Process in the context of a unitary business, a state that could tax the underlying earnings of an unincorporated foreign division could instead tax the dividends paid by that division if it operated as an incorporated foreign subsidiary. But that is a far cry from contending, as the United States does here, that in determining whether Iowa's tax *on such dividends* is discriminatory, it is necessary to take into account how the underlying earnings of the dividend-paying subsidiaries are also taxed. Such a theory completely disregards the separateness of the taxes imposed on the different entities involved. Cf. *Container Corp.* v. *Franchise Tax Board,* 463 U.S. 151, 191 n.30 (1983).

As for the alleged deficiency in the record below, the trial court specifically found as follows:

> In 1981, Kraft's foreign subsidiaries declared and paid dividends to Kraft. The foreign countries in which these foreign subsidiaries were located required the subsidiaries to withhold income taxes imposed by the countries upon the declared dividends of Kraft and to remit such taxes. In addition, the foreign subsidiaries were taxed directly by the foreign countries upon their earnings, from which the dividends to Kraft were declared. Thus, the foreign countries, utilizing the "arms-length" approach to income taxation, taxed the earnings represented by the foreign dividends twice, once to the foreign subsidiaries and second to Kraft.

(Pet. 12a. See also Pet. 2a; Pet. 29a-30a, Stip. 7-8; and Pet. 52a-53a.) The record thus clearly shows that five different countries taxed both the underlying earnings of petitioner's foreign subsidiaries and the dividends remitted by those subsidiaries.

Thus, even if it were somehow appropriate to consider the taxes imposed by other jurisdictions on other entities, the record below fully supports petitioner's claim of impermissible discrimination by Iowa. Three separate layers of tax have been imposed on the total income stream of petitioner's foreign subsidiaries—a foreign income tax on underlying earnings, a foreign withholding tax on dividends when paid, and an Iowa tax on those dividends when received. (Pet. 12a, 14a)[3]

The income stream of a domestic subsidiary carrying on business in the U.S. cannot be subjected to a similar tax burden. The only comparable taxes that could be imposed on a domestic subsidiary's underlying earnings would be the income tax imposed at the federal level, and whatever income tax may be imposed at the state level. Iowa does not, of course, tax domestic subsidiary dividends when received.

A maximum of two layers of tax on the income stream of a domestic subsidiary, compared with three layers of tax on the income stream of petitioner's foreign subsidiaries, undeniably establishes the existence of an impermissible burden on foreign commerce and resulting preference to domestic commerce under the Iowa taxing scheme.

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[3] A potential fourth layer of tax, the federal income tax also imposed on foreign subsidiary dividends, was offset by allowable foreign tax credits. (Pet. 32a, Stip. 16)

The facially discriminatory nature of the Iowa tax statute makes a determination of the degree of such burden and preference irrelevant. In *Bacchus Imports, Ltd.* v. *Dias*, 468 U.S. 263 (1984), a case involving facial discrimination, this Court expressly reaffirmed the well-settled proposition that it "need not know how unequal the Tax is before concluding that it unconstitutionally discriminates" (quoting from *Maryland* v. *Louisiana*, 451 U.S. 725, 760 (1981)). 468 U.S. at 269. See also *Armco Inc., supra.*

Significantly, the analogy between *Armco* and the instant case is virtually perfect. Under the West Virginia taxing scheme there involved, if an item was manufactured in West Virginia a tax *was not* imposed on an in-state sale of the item at wholesale. Instead, a tax was imposed on the manufacturing activity in the state. By contrast, if the item was manufactured out-of-state, a tax *was* imposed on its in-state sale, whether or not there was also a manufacturing tax imposed in the seller's home state. This Court held that the West Virginia tax scheme facially discriminated against interstate commerce.

Here, if the income is earned by a domestic subsidiary, Iowa *does not* impose a tax on the dividends paid from those earnings, whether or not the subsidiary's income is taxed by Iowa or any other state. By contrast, if the income is earned by a foreign subsidiary, Iowa *does* impose a tax on the dividends paid from those earnings, whether or not there has also been a foreign income tax imposed on the same earnings and/or a foreign withholding tax imposed on the dividends themselves. Since the facial differentiation in the West Virginia taxing scheme constituted impermissible "discrimination," the facial differentia-

tion in the Iowa taxing scheme must also constitute impermissible "discrimination."

* * *

The instant case raises for the first time one of the most fundamental constitutional questions presented under the Foreign Commerce Clause—the scope of the third prong "discrimination" test of *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274 (1977), as extended to foreign commerce by *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979). In its decision below, the Iowa Supreme Court made known its doubts about how that test is to be applied. ("...Supreme Court decisions are unclear whether such a local bias must be found when discrimination against foreign commerce is alleged. . . .") (Pet. 7a.) The Rhode Island District Court, Sixth Division, in a decision involving the identical issue here presented but rendered after the petition was filed in the instant case, expressed similar uncertainty. ("The Supreme Court seems to be adopting a laissez-faire attitude in these cases (except for *Japan Line*).") (*Dart Indus.* v. *Clark*, June 19, 1991, Slip Op. 5, lodged with the Clerk of this Court.)

Iowa, along with Rhode Island and eight other states (Pet. 6-7), disadvantages companies that rely for capital on dividends from foreign subsidiaries and benefits companies that rely for capital on dividends from domestic subsidiaries. It does so by exposing capital generated in foreign commerce to an additional layer of tax to which capital generated in domestic commerce is not exposed. Individual states are not free to burden foreign commerce and benefit domestic commerce in such a manner.

State courts are groping to determine how properly to resolve the important question presented by the instant case. The arguments offered by the United States as to why the petition should be denied are based on an inaccurate reading of the record and a novel and unsupported theory of constitutional law. The views of the United States thus should be accorded no weight in this Court's deliberative process.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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QUESTIONS PRESENTED

1. Whether a state statute can be found to discriminate impermissibly against foreign commerce in violation of the Foreign Commerce Clause without a showing that the discrimination provides a commercial advantage to purely local businesses.

2. Whether the Iowa Business Tax on Corporations, which facially discriminates against foreign commerce by including foreign subsidiary dividends in the Iowa tax base while excluding domestic subsidiary dividends from that base, violates the Foreign Commerce Clause.

3. Whether the Iowa Business Tax on Corporations violates the Equal Protection Clause because its classification of dividend income is not rationally related to a legitimate state purpose.

RULE 29.1 STATEMENT

The parent company of petitioner is Philip Morris Companies, Inc. The subsidiaries of petitioner, other than wholly-owned subsidiaries, are listed in the Appendix to the Brief at pages 1a - 3a.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

No. 90-1918

KRAFT GENERAL FOODS, INC.
(formerly KRAFT, INC.),
Petitioner,

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE,
Respondent.

On Writ of Certiorari to the Supreme Court of Iowa

BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion of the Supreme Court of Iowa (reproduced in the Appendix to the petition for a writ of certiorari (Pet. App. at 1a-10a)) and the order of the Supreme Court of Iowa denying rehearing (Pet. App. 57a) were reported at 465 N.W.2d 664 (Iowa 1991). The findings of fact, conclusions of law, and judgment of the District Court of Iowa in and for Polk County (Pet. App. 11a-23a) have not been reported. The order of the Iowa Department of Revenue and Finance (Pet. App. 24a-27a) has not been reported.

JURISDICTION

The judgment of the Supreme Court of Iowa was entered on February 20, 1991. Petitioner's timely petition for rehearing was denied on March 19, 1991. (Pet. App. 57a) The petition for a writ of certiorari was filed on June 14, 1991, and was granted on January 21, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the Constitution, art. I, sec. 8, cl. 3 provides: The Congress shall have power "[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

The Equal Protection Clause of the United States Constitution, amend. XIV, sec. 1, provides that: "No state shall . . . deny to any person within its jurisdiction the equal protection of the laws."

Relevant portions of sections 422.33 and 422.35 of the Iowa Code, Sections 243, 901, 902, 1504, and 7701 of the Internal Revenue Code, and section 1.1502-14(a)(1) of the Federal Income Tax Regulations are set forth in Pet. App. 58a-63a, 64a-70a, and 71a, respectively. Relevant portions of sections 61, 78, and 164 of the Internal Revenue Code and section 422.35 of the Iowa Code are set forth in the Appendix to this Brief ("A"), 3a-11a.

STATEMENT

A. Relevant Facts

Petitioner is a Delaware corporation with its principal office and commercial domicile in Illinois. It is

engaged in the production, processing, and distribution of food and food products. Petitioner conducts a unitary business in Iowa, other states, and various foreign countries.

In 1981, petitioner owned more than 80 percent of the capital stock of six corporations that were part of its unitary business and that conducted their business activities exclusively outside the United States. Those subsidiaries (and their respective countries of incorporation) were Dominion Dairies Ltd. (Canada); Kraft Limited (Canada); Kraft Foods S/A (Denmark); Kraft G.m.b.H.(Germany); Kraft S.p.A. (Italy); and Alimentos Kraft de Venezuela C.A.(Venezuela). (Pet. App. 29a and 52a)

For a variety of reasons, U.S. corporations conducting business abroad typically do so through subsidiary corporations organized in the countries in which they operate. The parties have stipulated that those reasons include, but are not limited to, the requirements of the foreign country, a better ability to limit the company's liability in that country, marketing advantages as customers perceive the subsidiary as a local company, greater ease in repatriating funds, greater ease in borrowing funds in the country of operation, and the ability to own property and to manufacture in that country. (Pet. App. 30a-31a)

During 1981, the six named subsidiaries paid to petitioner, out of the earnings of their foreign operations, aggregate dividends of $10,181,815. The dividends were part of petitioner's unitary business income. (Pet. App. 33a and 53a) Foreign withholding taxes of $1,490,887 were imposed on the dividends by the countries where the foreign subsidiaries operated. (Pet. App. 53a) In addition, the earnings of

the subsidiaries from which the dividends were paid were subjected to foreign income tax by those countries. (Pet. App. 12a)

B. Iowa Taxing Scheme

The Iowa Business Tax on Corporations imposes an income tax on that portion of the "net income" of a corporation that is reasonably attributable to its trade or business carried on within Iowa. The amount of income subject to tax by Iowa is determined by application of the state's allocation and apportionment rules to the corporation's total "net income." (Pet. App. 58a-62a)

Iowa uses federal law as the starting point for calculating its corporate tax base. In 1981, the relevant Iowa statute defined "net income" as "the taxable income . . . properly computed for federal income tax purposes under the Internal Revenue Code", with certain specified adjustments. (Pet. App. 62a)[1]

1. Calculation of Federal "Taxable Income"

Under the federal Internal Revenue Code, dividends from subsidiaries are included in a corporation's "gross income." 26 U.S.C. § 61. In computing federal "taxable income," the Internal Revenue Code allows a corporation to deduct from its gross income a certain percentage of the dividends it has received from "a domestic corporation which is subject to [federal income] taxation." 26 U.S.C. § 243.[2] (This deduction

[1] The current Iowa Code provisions are essentially the same. Iowa Code §§ 422.33, 422.35 (1990 & Supp. 1991).

[2] A "domestic corporation" is defined as a corporation created or organized in the United States or under the law of the United States or of any State. 26 U.S.C. § 7701(a)(4).

is known as the "dividends-received-deduction.") If both the payor and recipient of the dividend are members of an "affiliated group" of domestic corporations, (*e.g.*, if the recipient corporation owns at least 80 percent of the capital stock of the payor), federal law allows a dividends-received-deduction equal to 100 percent of the dividends received. 26 U.S.C. §§ 243, 1504.[3] The 100 percent dividends-received-deduction has the effect of exempting "domestic subsidiary dividends" from federal income tax.[4]

Federal law does not permit a corporation to deduct any portion of the dividends it receives from a foreign subsidiary that conducts its business operations exclusively in a foreign country.[5] "Foreign subsidiary

[3] Dividends eligible for the full 100 percent dividends-received-deduction are referred to herein as "domestic subsidiary dividends."

[4] If the recipient and payor corporations are not members of an affiliated group the amount of the dividends-received-deduction is reduced. In 1981, the reduced deduction equalled 85 percent of the dividends received. 26 U.S.C. § 243. (1976 & Supp. V 1981). Under current law, the deduction is equal to either 80 percent or 70 percent of the dividends received, depending upon the recipient's level of stock ownership in the payor. 26 U.S.C. § 243.

Members of an affiliated group of corporations may elect to file a single consolidated federal income tax return in lieu of separate returns. If a consolidated return is filed, dividends paid by one member to another are "eliminated" from taxable income, producing the same result as a 100 percent dividends-received-deduction. Treas. Reg. § 1.1502-14(a)(1). Only domestic corporations are eligible to file a federal consolidated return. 26 U.S.C. § 1504(b).

[5] Dividends received from a foreign subsidiary that is at least 80 percent-owned by its U.S. parent and that conducts its busi-

dividends" are thus fully includible in federal taxable income.[6]

Federal law excludes "domestic subsidiary dividends" from taxable income because they are paid from income that itself is subject to U.S. tax as earned by the domestic subsidiary. The dividends-received-deduction is designed to avoid federal double taxation of corporate earnings while they remain in corporate solution.

Federal law includes "foreign subsidiary dividends" in taxable income because the underlying earnings of the foreign subsidiary are not subject to U.S. tax. To mitigate the consequences of international double taxation, the Internal Revenue Code allows a recipient of foreign subsidiary dividends a credit against its U.S. tax liability for foreign taxes withheld from the dividends and for foreign taxes paid by the subsidiary on the income from which the dividends were paid.[7]

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ness entirely outside the United States are referred to herein as "foreign subsidiary dividends."

[6] The Internal Revenue Code allows a deduction for dividends received from a foreign subsidiary that carries on business in the United States. 26 U.S.C. § 245. The amount of the deduction generally reflects the extent of the foreign subsidiary's U.S. business activity.

[7] If a parent corporation claims a foreign tax credit with respect to foreign subsidiary dividends, it is required to include in its income (as an additional "dividend") the amount of foreign income taxes paid by the subsidiary on the earnings from which the dividends were paid. 26 U.S.C. § 78. That inclusion is known as the "gross-up" amount.

As an alternative to the foreign tax credit, the Internal Revenue Code allows a deduction for foreign withholding taxes imposed. 26 U.S.C. § 164 (allowing a deduction for state, local,

Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶¶ 5.05 and 17.11 (5th ed. 1987).

2. Calculation of Iowa "Net Income"

As noted, Iowa adopts federal "taxable income" as the starting point for determining the corporate "net income" that it subjects to tax after apportionment. As a result, a corporation doing business in Iowa calculates its Iowa tax base with (1) "domestic subsidiary dividends" fully excluded, by virtue of the 100 percent federal dividends-received-deduction, and (2) "foreign subsidiary dividends" fully included, by virtue of the absence of a federal deduction with respect to such dividends.

Iowa does not adopt all provisions of the Internal Revenue Code, however. For example, it does not allow a credit against Iowa tax liability for foreign taxes incurred with respect to a foreign subsidiary dividend.[8]

As illustrated by Exhibits 4 and 5 to the Stipulation below (Pet. App. 55a-56a), Iowa's taxing scheme exposes a corporation receiving a $100,000 foreign subsidiary dividend to a tax burden to which an otherwise similarly situated corporation receiving a $100,000 domestic subsidiary dividend is not exposed. The result is the imposition of a discriminatory income tax on

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and foreign income taxes paid or incurred). A credit against tax liability is generally more valuable to a taxpayer than a deduction.

[8] If the taxpayer has claimed a foreign tax credit for federal purposes, Iowa excludes the "gross-up" amount from the computation of the taxpayer's "net income" for Iowa tax purposes. (Pet. App. 56a) (A 4a-5a)

any corporation operating in Iowa whose unitary business income includes dividends from subsidiaries organized and operating in foreign countries.

C. Similar State Taxing Schemes

In addition to Iowa, 40 states currently utilize federal taxable income as the starting point for calculating net income subject to corporate income tax.[9] Ten of those states adopt the federal tax distinction between foreign and domestic subsidiary dividends.[10] Three of the ten states discriminate in identical fash-

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[9] Five states with a corporate income tax (Alabama, Arkansas, California, Mississippi, and Utah) plus the District of Columbia do not utilize federal taxable income as the starting point in their calculations. Four other states (Nevada, South Dakota, Washington, and Wyoming) do not impose a corporate income tax. See Pet. App. 73a-75a for all state statutory citations except Texas and Pennsylvania, which are contained herein at nn. 11, 12, *infra*, respectively.

[10] Fifteen of the 40 states exclude both domestic and foreign subsidiary dividends from their tax base calculation. Arizona, Connecticut, Delaware, Florida, Georgia, Illinois, Indiana, Kentucky, Maryland, Michigan, Nebraska, Ohio, Texas (1991 Tex. Sess. Law. Serv. 1st C. Sess. Ch.5 (H.B. 11) § 171.110 (Vernon), effective for taxable years beginning on or after January 1, 1992; Texas previously did not impose a corporate income tax), Virginia, and West Virginia.

Eleven states include both types of dividends in the calculation. Hawaii, Louisiana, Massachusetts, Minnesota, New Jersey, New York, North Carolina, North Dakota, Oregon, Tennessee, and Wisconsin.

Four states (Alaska, Idaho, Montana, and New Hampshire) that utilize federal taxable income have adopted variations on the federal law that make comparisons inappropriate.

ion with Iowa,[11] and seven do so with certain modifications.[12] Two other jurisdictions that do not follow the federal scheme discriminate in a manner similar to Iowa.[13]

D. Proceedings Below

In calculating its federal taxable income for the taxable year 1981, petitioner included its foreign subsidiary dividends in income in accordance with applicable federal rules. (Pet. App. 32a) (Petitioner received no domestic subsidiary dividends in that year.) Petitioner also claimed a credit against its federal tax liability for the foreign taxes attributable to its foreign subsidiary dividends. (*Id*)

In calculating its 1981 "net income" for purposes of the Iowa Business Tax on Corporations, petitioner deducted its foreign subsidiary dividends from the amount of federal taxable income it had separately calculated. The Iowa Department of Revenue and Finance ("the Department") assessed additional tax against petitioner on the ground that its foreign subsidiary dividends should have been included in petitioner's Iowa tax base. (Pet. App. 13a-14a)

Before the Department, petitioner challenged the constitutionality of the Iowa taxing statute under the Commerce Clause and the Equal Protection Clause of

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[11] New Mexico, Vermont, and, most recently, Pennsylvania (1991 Pa. Legis. Serv. Act 1991-22 (H.B. 185) § 401(3)(1)(b) (Purdon), as amended on August 4, 1991 and effective for taxable years beginning on or after January 1, 1991; Pennsylvania previously excluded all dividends from corporate taxable income).

[12] Colorado, Kansas, Maine, Missouri, Oklahoma, Rhode Island, and South Carolina.

[13] Alabama and the District of Columbia.

the United States Constitution and on other grounds. The Iowa Director of Revenue declined to render a decision on the ground that he had no authority to decide the "facial constitutionality" of the statute. (Pet. App. 26a)

On review, the District Court of Iowa in and for Polk County ("District Court") held that the statute did not discriminate in violation of the Commerce Clause because it did not benefit "local in-state industry in detriment to out-of-state industry." (Pet. App. 16a-17a) The District Court also held that the tax did not result in multiple taxation in violation of the Commerce Clause, an argument that petitioner did not pursue further. (Pet. App. 18a-22a) Finally, the District Court held that the statute did not violate the Equal Protection Clause because the Department's rationale for using federal taxable income as its starting point—convenience to the taxpayer and the State—was rationally related to a legitimate state purpose. (Pet. App. 23a)

The Supreme Court of Iowa affirmed. After noting that "Supreme Court decisions are unclear whether such a local bias must be found when discrimination against foreign commerce is alleged," the court held that the Iowa taxing scheme did not violate the Commerce Clause because it did not benefit Iowa businesses at the expense of foreign businesses. (Pet. App. 7a-8a) The Iowa Supreme Court also agreed with the District Court that the Equal Protection Clause was not violated because the State's purpose in using federal taxable income as its starting point—taxpayer and administrative convenience—was a legitimate purpose. (Pet. App. 10a)

The total amount of tax assessed against petitioner by respondent for 1981 was approximately $39,000 (Pet. App. 33a), of which approximately $17,000 was attributable to the issue here presented. The outcome of this case will affect taxable years of petitioner from 1978 forward. (Pet. App. 43a)

SUMMARY OF ARGUMENT

The Iowa taxing scheme facially discriminates against foreign commerce by including foreign subsidiary dividends in its corporate tax base while excluding domestic subsidiary dividends from that base. For that reason, it must be struck down without further inquiry.

The Iowa Supreme Court and respondent before this Court have taken the position that the Iowa statute is not impermissibly discriminatory because it confers no particular benefit on Iowa businesses or Iowa activity that is not conferred on other domestic businesses or other domestic activities.

The "local advantage" test adopted by the court below finds its origins in this Court's decisions involving the Interstate Commerce Clause. It has no application to challenges arising under the Foreign Commerce Clause. Prior decisions of this Court dating back to 1878 have established that a state taxing scheme that facially discriminates against foreign commerce will be struck down without requiring a showing of local benefit.

A state taxing statute like Iowa's necessarily interferes with the free flow of foreign commerce in direct contradiction to the purpose and intent of the Foreign Commerce Clause. Insisting upon a showing

of benefit to "local commerce," as was done by the court below, improperly limits the intended reach of that Clause.

This Court's analysis in *New Energy Co.* v. *Limbach*, 486 U.S. 269 (1988), does not validate the Iowa statute. First, that analysis is not applicable here because, unlike *New Energy*, the instant case does not even arguably involve an indirect exercise of police power through a taxing statute. Moreover, the State's asserted purpose of convenience can easily be achieved by a reasonable nondiscriminatory means: subtracting foreign subsidiary dividends from the tax base.

The Iowa statute also deprives petitioner of the equal protection of the laws. Taxpayer and administrative convenience, the only reason offered for the classification of dividend income, is not a legitimate purpose here. Even if it were legitimate, the numerous and complex adjustments to federal taxable income required to compute Iowa net income illustrate that the taxing scheme as a whole is not rationally related to that purpose. Iowa's decision to pick and choose which federal numbers to incorporate in its tax base makes its taxing scheme "wholly arbitrary" as applied to dividend income.

ARGUMENT

I. IOWA'S METHOD OF TAXING DIVIDEND INCOME IMPERMISSIBLY DISCRIMINATES AGAINST FOREIGN COMMERCE.

Despite its power to do so, Congress has not chosen to enact comprehensive legislation designed to regu-

late state taxation of income.[14] Thus, federal law does not require the states to tax dividend income in any particular manner. *Mobil Oil Corp.* v. *Commissioner of Taxes* 445 U.S. 425, 448-449 (1980). The absence of federal regulation does not, however, leave the states free to tax such income in any manner they please. As this Court stated in *Wardair Canada, Inc.* v. *Florida Department of Revenue*, 477 U.S. 1 (1986), where the federal government has not affirmatively acted, "it is the responsibility of the judiciary to determine whether action taken by state or local authorities unduly threatens the values the Commerce Clause was intended to serve." *Id.* at 7.

This Court has developed a six-part test for determining whether a state taxing statute violates the Foreign Commerce Clause. The first four prongs of that test, originally developed in the interstate commerce context in *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, 279 (1977), ask whether the tax is (1) applied to an activity with a substantial nexus with the taxing state; (2) fairly apportioned; (3) nondiscriminatory; and (4) fairly related to the services provided by the state.

In *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979), this Court extended the application of the *Complete Auto* four-prong test to challenges under the Foreign Commerce Clause. Noting that when foreign commerce is involved "a more extensive

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[14] To date, Congress has limited its regulation of state income taxation to Pub.L. No. 86-272, which precludes states from imposing a tax on income attributable to mere solicitation within a state. 15 U.S.C. § 381 (1988). See *Wisconsin Dep't of Rev.* v. *William Wrigley, Jr., Co.*, No. 91-119, now pending on certiorari.

constitutional inquiry is required," this Court added two additional prongs to the *Complete Auto* test. They ask whether the tax (1) creates a substantial risk of international multiple taxation; and (2) prevents the federal government from speaking with one voice when regulating commercial relations with foreign governments. *Id.* at 446, 451. *See also Wardair, supra*, 477 U.S. at 8.

Petitioner's Commerce Clause challenge to the Iowa statute here in question arises solely under the "discrimination" prong of the six-part test.[15]

A. The Iowa Taxing Scheme Facially Discriminates Against Foreign Commerce.

Petitioner is a multinational enterprise that operates a unitary business throughout the United States and in various foreign countries. Among the sources of capital on which petitioner relies to conduct its business are dividends received from its foreign subsidiaries. During 1981, the year here at issue, petitioner received dividends from six foreign subsidiaries that conducted their respective business operations in five different countries. In that year, the flow of capital from those foreign subsidiaries to petitioner exceeded $8 million, net of foreign withholding taxes. Petitioner received no domestic subsidiary dividends in 1981.

Because petitioner conducts a portion of its unitary business in Iowa, it is subject to Iowa's Business Tax

[15] This issue was not considered by this Court in *Mobil, supra*. There, the taxpayer challenged the constitutionality of a Vermont statute that was virtually identical to the Iowa statute now under review, but on grounds not raised by petitioner here.

on Corporations. That tax is imposed on the portion of petitioner's total net income from its unitary business that is properly apportioned to Iowa.[16] The Iowa statute, read in conjunction with the appropriate incorporated provisions of the federal Internal Revenue Code, requires petitioner to include dividends received from its foreign subsidiaries (but not its domestic subsidiaries) in the calculation of its unitary business income subject to apportionment. The Iowa taxing scheme thus burdens the flow of capital from foreign subsidiaries without similarly burdening the flow of capital from domestic subsidiaries.[17]

This Court's decisions dating back over 100 years make it clear that imposing such a discriminatory burden on foreign commerce violates the Foreign Commerce Clause. In *Cook* v. *Commonwealth of Pennsylvania*, 97 U.S. 566 (1878), this Court considered the validity of a Pennsylvania statute that levied a tax on auctioneers, measured by the proceeds of items sold at auction. An exemption was provided for "gro-

[16] In *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267 (1978), this Court upheld the validity of Iowa's single factor apportionment formula.

[17] The fact that Iowa's statute facially discriminates in the composition of the tax base, rather than by imposing a discriminatory tax *per se*, cannot be of constitutional significance. A state discriminates against foreign commerce whether it taxes such commerce at a higher rate or includes in its tax base certain types of income when generated in foreign commerce but not when generated in domestic commerce. *Cf. Westinghouse Elec. Corp.* v. *Tully*, 466 U.S. 388, 404-405 (1984).

Nothing in *Shell Oil Co.* v. *Iowa Dep't of Revenue*, 488 U.S. 19 (1988), is inconsistent with this conclusion. *Shell* involved questions of extraterritoriality, not discrimination, in the composition of the Iowa tax base.

ceries, goods, wares, and merchandise of American growth or manufacture." *Id.* at 569.

This Court held that the Pennsylvania tax was a tax on the goods sold, and that its discriminatory nature caused it to violate both the Import-Export Clause and the Foreign Commerce Clause. Referring to its prior decision in *Welton v. Missouri*, 91 U.S. 275 (1876), which struck down a state statute that discriminated against goods produced in other states, this Court declared:

> The Congress of the United States is granted the power to regulate commerce with foreign nations in precisely the same language as it is that among the States. If a tax assessed by a State injuriously discriminating against the products of a State of the Union is forbidden by the Constitution, a similar tax against goods imported from a foreign State is equally forbidden.
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> In granting to Congress the right to regulate commerce with foreign nations and among the several States, and with the Indian Tribes, and in forbidding the States without the consent of that body to levy any tax on imports, the framers of the Constitution believed that they had sufficiently guarded against the dangers of any taxation by the States which would interfere with the freest interchange of commodities among the people of the different States, and by the people of the States with citizens and subjects of foreign governments.

Id. at 573-574. *Cook* v. *Pennsylvania* stands unmistakably for the proposition that individual States cannot single out foreign commerce for taxation without violating the Foreign Commerce Clause.

In *Hale* v. *Bimco Trading, Inc.*, 306 U.S. 375 (1939), this Court again struck down a statute that improperly discriminated against foreign commerce by exposing such commerce to burdens that domestic commerce was not required to bear. The statute at issue in *Hale* mandated the inspection of, and the payment of an inspection fee with respect to, cement imported into Florida from any foreign country. Those burdens were not imposed on cement produced in Florida or any other state. Acknowledging "discrimination in the incidence of an obviously onerous exaction as between foreign and domestic cement," *id.* at 379, this Court, citing *Cook* v. *Pennsylvania*, held that the Florida statute violated the Foreign Commerce Clause.

Like the statutes involved in *Cook* and *Hale*, the Iowa taxing statute on its face exposes foreign commerce to a burden to which domestic commerce is not exposed. As this Court held in *Armco Inc.* v. *Hardesty*, 467 U.S. 638 (1984), such a facially discriminatory statute must be struck down as unconstitional without further inquiry.[18]

B. The Court Below Upheld the Iowa Taxing Scheme By Applying an Erroneous Test.

The Iowa Supreme Court framed the test for determining impermissible discrimination against for-

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[18] *See also Tyler Pipe Indus. Inc.* v. *Washington Dep't of Rev.*, 483 U.S. 232 (1987). That *Armco* and *Tyler Pipe* involved interstate commerce rather than foreign commerce cannot affect this conclusion.

eign commerce as whether "Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme." (Pet. App. 7a) In applying that test, the Iowa court apparently believed that it was required to adopt without modification the "local commercial advantage" test that this Court has applied in the interstate commerce context. *See, e.g., Bacchus Imports, Ltd.* v. *Dias*, 468 U.S. 263, 268 (1984). The court below held that "[b]ecause the Iowa tax does not differentiate between in-state or out-of-state taxpayers, no impermissible discrimination exists." (Pet. App. 7a-8a)

The Iowa court expressed genuine uncertainty as to whether it was applying the appropriate test. (Pet. App. 7a)[19] Its doubts were well-founded. This Court's decisions do not require a differentiation in the treatment of "in-state or out-of-state" *domestic* businesses

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[19] The only citation offered by the court below to support its application of the "local advantage" test in this foreign commerce case was a passage quoted out of context from Tatarowicz and Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 Vand. L. Rev. 879, 941 (1986). The passage quoted by the court was addressing a tax that discriminated against interstate commerce and *in favor of* foreign commerce. The commentators expressed quite a different view where, as is true in the instant case, the statute discriminates in favor of interstate commerce and *against* foreign commerce.

> It is also unclear whether a state tax provision can favor interstate commerce over foreign commerce. The additional protection afforded foreign commerce renders it unlikely that such a provision would be held constitutional.

Id. at 941 n.298.

in order to find that a statute impermissibly discriminates against *foreign* commerce.

As noted, the statute at issue in *Cook* v. *Pennsylvania, supra*, exempted all American goods, not merely goods produced in Pennsylvania. This Court did not require a showing that Pennsylvania goods enjoyed an advantage over other domestic goods, or even that Pennsylvania goods were being sold, before holding the statute unconstitutional. (The court below responded to this Court's holding in *Cook* by ignoring it.)

The statute at issue in *Hale* v. *Bimco Trading, Inc., supra*, exempted all domestic cement, not merely cement produced in Florida. While the legislative history suggested a desire to benefit the Florida cement industry, this Court did not require a showing that Florida cement enjoyed an advantage over other domestic cement before declaring the law invalid. *Hale* was identical to *Cook* in that regard. In both cases, this Court used the same analysis to reach the same result. (The court below chose to treat *Hale* as a "local advantage" case.)

The decisions in *Cook* and *Hale* reflect this Court's full recognition of the original purpose and thrust of the Foreign Commerce Clause. Both that Clause and the Import-Export Clause were directed in large part at curtailing the power of the coastal States to tax foreign commerce to the detriment of their sister States. As this Court observed in *Michelin Tire Corp.* v. *Wages*, 423 U.S. 276 (1976):

> One of the major defects of the Articles of Confederation, and a compelling reason for the calling of the Constitutional Convention

> of 1787, was the fact that the Articles essentially left the individual States free to burden commerce both among themselves and with foreign countries very much as they pleased.

Id. at 283.

Nothing in *Michelin* suggests that the Framers were motivated by complaints that the States were using their taxing powers for the benefit of local commerce. The strongest concerns manifested were directed at the unrestrained zeal of certain States in taxing foreign goods that were destined for neighboring States. *Michelin, supra,* at 283-286.[20]

This Court has acknowledged that both the Foreign Commerce Clause and the Import-Export Clause were aimed in part at preserving harmony among the States by precluding the imposition of taxes on goods merely passing through one State en route to another State.[21] Early case law that dealt with the discriminatory nature of state taxation tended to involve taxes

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[20] The extensive historical analysis undertaken in *Michelin,* while focused on the purposes of the Import-Export Clause, is directly relevant here because of the overlap between that Clause and the Foreign Commerce Clause. *See, e.g., Japan Line, supra,* at 449 n.14 ("The policies animating the Import-Export Clause and the Commerce Clause are much the same."); *Department of Rev.* v. *Association of Washington Stevedoring Cos.,* 435 U.S. 734, 754-755 (1978) (applying four-prong *Complete Auto* test to challenge under Import-Export Clause.)

[21] The other two objectives of both Clauses were to ensure that the federal government spoke with one voice in all matters involving foreign relations and that import duties would become the major source of federal revenue. *Michelin, supra,* at 285-286; *Japan Line, supra,* at 449 n.14.

on goods originating in sister states.[22] *Cook* v. *Pennsylvania* appears to have been the first case to address squarely the question of discrimination against foreign goods. *Cook* established that a specific showing of "local advantage" was not essential to a determination that a State had violated the Foreign Commerce Clause when it singled out foreign goods for taxation.[23]

Japan Line offers the most current guidance on this question. In discussing concerns of multiple taxation where foreign commerce is involved, this Court declared that a state tax "may subject foreign commerce 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.' " *Id.* at 448 (brackets in

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[22] *E.g., Woodruff* v. *Parham,* 75 U.S. 123 (1869), and *Hinson* v. *Lott,* 75 U.S. 148 (1869), both of which upheld taxing statutes that were found to be nondiscriminatory because they applied to goods produced locally as well as goods produced in other States; *Welton* v. *Missouri,* 91 U.S. 275 (1876), which struck down a statute that taxed sellers of goods brought into Missouri from other states.

[23] *Cook* addressed a point left open in the landmark case of *Brown* v. *Maryland,* 25 U.S. 419 (1827). After striking down under both the Import-Export Clause and the Foreign Commerce Clause a Maryland license fee imposed on importers and sellers of goods in their imported state, Chief Justice Marshall concluded his analysis by stating:

> We do not mean to give any opinion on a tax discriminating between foreign and domestic articles.

Id. at 449. Chief Justice Marshall apparently did not consider the Maryland license fee in terms of its possible discriminatory effect, but only in terms of its effect on imports *qua* imports. See *Michelin, supra,* at 288 n. 7, discussing certain Import-Export Clause implications of *Brown* v. *Maryland.*

original), quoting from *Evco* v. *Jones*, 409 U.S. 91, 94 (1972), which in turn quoted from *J.D. Adams Mfg. Co.* v. *Storen*, 304 U.S. 307, 331 (1938), both of which involved "interstate commerce" issues. By replacing the original word "intrastate" used in *J.D. Adams Mfg. Co.* with the bracketed word "[domestic]," this Court clearly signalled in *Japan Line* that, at most, proper Foreign Commerce Clause analysis compares the effect of a challenged tax on foreign commerce with its effect on domestic commerce in general, not merely on local commerce.

Japan Line reflects what this Court previously observed in *Cook*—the Framers intended that the Foreign Commerce Clause protect against the dangers of any state taxation that might interfere with the "freest interchange" between domestic and foreign commercial interests. *Cook*, *supra*, at 573. Requiring a showing of "local advantage" fails to give full effect to the intended scope of that Clause.

Against this backdrop, there is little doubt that the facially discriminatory Iowa taxing scheme constitutes an impermissible attempt to regulate foreign commerce. Iowa seeks to tax capital transferred *into* this country in the form of dividends from foreign subsidiaries. It makes no attempt to tax capital transferred *within* this country in the form of dividends from domestic subsidiaries. The discrimination is obvious. To uphold the Iowa statute would be totally inconsistent with the intention of the Framers.

C. *New Energy* Provides No Support For Respondent.

Relying on *New Energy Co.* v. *Limbach*, 486 U.S. 269 (1988), respondent, in its Brief in Opposition, attempted to justify Iowa's discriminatory treatment of

foreign subsidiary dividends by arguing that its reason for such treatment is "justified by a valid factor unrelated to economic protectionism." (Br. Opp. 16-18, quoting *New Energy* at 274.) *New Energy* does not provide support for respondent's position here.

First, *New Energy* was unusual in its application of a regulatory discrimination analysis to a taxing statute. The reason for this Court's approach in that case seems clear. Ohio attempted to justify its discriminatory taxation of out-of-state ethanol on health grounds. This Court presumably felt compelled to apply its regulatory balancing test because the state had arguably exercised its police power indirectly through the taxing statute. In the instant case, however, Iowa does not attempt to justify its facially discriminatory taxation of dividends as an indirect exercise of its police power. It simply offers "convenience" as the purpose for its discrimination. Convenience, of course, has no relationship to the exercise of the state's police power. Thus, an application of the *New Energy* balancing test is not appropriate in these circumstances.

Moreover, even if the *New Energy* analysis were considered applicable, it would not sanction the discrimination here at issue. As this Court there explained, a discriminatory statute may survive constitutional challenge only if the state can show it "advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives." *New Energy*, at 278. "Convenience," the alleged local purpose here, can easily be served by excluding foreign subsidiary dividends from the Iowa tax base. Such an adjustment to the federal computation would require virtually no effort by taxpayers. It also would not reduce the alleged benefit Iowa finds

in relying primarily on the federal system in calculating net income subject to apportionment. Assuming, arguendo, that "convenience" is a "legitimate local purpose" in this context, its objectives can adequately be served by a reasonable nondiscriminatory alternative to the present system of dividend taxation.

New Energy thus does not support respondent's claim that Iowa's discriminatory taxing scheme is constitutionally permissible.

II. IOWA'S CLASSIFICATION OF DIVIDEND INCOME DENIES PETITIONER EQUAL PROTECTION BECAUSE IT IS NOT RATIONALLY RELATED TO A LEGITIMATE STATE PURPOSE.

This Court has not hesitated to invoke the Equal Protection Clause to reject attempts by a state to tax one class of taxpayers on a more onerous basis than another similarly situated class. *Williams* v. *Vermont*, 472 U.S. 14 (1985); *WHYY, Inc.* v. *Borough of Glassboro*, 393 U.S. 117 (1968); *Wheeling Steel Corp.* v. *Glander*, 337 U.S. 562, 572 (1949). Iowa's discriminatory classification can only survive an equal protection challenge if it is "rationally related to achievement of a legitimate state purpose." *Western & S. Life Ins. Co.* v. *State Bd. of Equalization*, 451 U.S. 648, 668 (1981).

A. Iowa's Classification Serves No Legitimate State Purpose.

As previously discussed, federal law excludes domestic subsidiary dividends from taxable income because their inclusion would result in U.S. double taxation of income in corporate solution. Federal law includes foreign subsidiary dividends in taxable income because the underlying income of foreign subsidiaries is not itself subject to U.S. tax. Federal law

does, however, allow a foreign tax credit to mitigate international double taxation.

The mere fact that the federal government treats domestic subsidiary dividends differently from foreign subsidiary dividends does not provide Iowa with a legitimate purpose for its discrimination. Action that is legitimate when taken at the federal level may become illegitimate when undertaken by a state. *Compare Mathews* v. *Diaz*, 426 U.S. 67 (1976) (alienage distinction in *federal* Medicare law does not violate equal protection) *with Graham* v. *Richardson*, 403 U.S. 365 (1971) (alien exclusion in *state* welfare law violates equal protection).

Unlike the federal system, the Iowa system clearly is not based on the avoidance of double taxation. Iowa excludes domestic subsidiary dividends from taxation even where the earnings from which they are paid are not subject to Iowa tax (*e.g.*, where a domestic subsidiary not taxable in Iowa pays a dividend to a parent company doing business in Iowa). In addition, Iowa offers no credit for foreign taxes paid with respect to foreign subsidiary dividends. Iowa's focus is not on double taxation at all, and its classification of dividends completely lacks a substantive tax policy justification.

In recognition of this fact, the Iowa Supreme Court based its Equal Protection conclusion on the ground that using federal "taxable income" as a basis for calculating Iowa "net income" was convenient for both the taxpayer and the State. According to the court below:

> "The taxpayer is permitted to merely lift the figures off the federal return and transfer

them to the Iowa franchise tax return." [quoting *First Nat'l Bank of Ottumwa* v. *Bair*, 252 N.W.2d 723, 726 (Iowa 1977)]

* * *

[T]he coupling of Iowa net income with the federal formula is convenient for the taxpayer, prevents the taxpayer from spending time and money on complex forms, provides a saving to the state, allows the state to rely on federal regulation and interpretation, and provides the state with an inexpensive and quick way of verifying the accuracy of taxpayers returns.

(Pet. App. 9a-10a)

Administrative convenience may be a legitimate reason for taxing two items differently when there is a meaningful difference in the nature of the items. For example, a state may tax out-of-state bank deposits of a local taxpayer at a higher rate than in-state bank deposits because it is more difficult and expensive to enforce collection of the tax on out-of-state deposits. *See Madden* v. *Kentucky*, 309 U.S. 83, 89-90 (1940).

Administrative convenience may also be a legitimate reason for taxing two taxpayers differently when there is a meaningful difference between the taxpayers. For example, a state may elect to tax employers with eight or more employees while exempting those with fewer than eight employees because the cost of measuring and administering the tax with respect to small employers may outweigh the revenue to be derived. *See Carmichael* v. *Southern Coal & Coke Co.*, 301 U.S. 495, 511 (1937).

Neither taxpayer nor administrative convenience, however, can be a legitimate reason for a classification where, as here, there is no meaningful difference in the nature of the items being taxed or in the taxpayers themselves. Allowing a state to claim "convenience" in order to justify the imposition of unequal burdens in such a case would make a mockery of the Equal Protection Clause.

It would no doubt be "convenient" for Iowa to tax all Delaware corporations doing business in Iowa by apportioning their "net income" as originally calculated for Delaware tax purposes: such corporations would not have to spend time and money preparing separate calculations on multiple forms, and the two states could reduce the cost of administering their tax systems and verifying the accuracy of tax returns by combining their audit efforts. But surely such separate treatment of Delaware corporations vis-a-vis other corporations doing business in Iowa would not be deemed to satisfy equal protection requirements merely because of the taxpayer and administrative convenience it would afford. If Iowa cannot, on grounds of convenience, treat the income of Delaware corporations differently from the income of non-Delaware corporations doing business in Iowa, why should it be allowed to treat domestic subsidiary dividends differently from foreign subsidiary dividends on the same ground?

B. Iowa's Taxing Scheme Is Not Rationally Related to a Purpose of Convenience.

Even if the goal of taxpayer and administrative convenience were a legitimate one in this context, Iowa's extensive modifications to federal "taxable income" for purposes of determining Iowa "net in-

come" undermine its claim that its taxing scheme is rationally related to that objective.

For the year 1981, Iowa's taxing statute required corporate taxpayers to make nine separate adjustments to their federal taxable income in order to determine their proper Iowa tax base. Iowa required taxpayers to: (1) subtract interest and dividends from federal securities; (2) add other interest and dividends exempt from federal tax; (3) adjust the basis used on the federal return for determining gain or loss on the sale of certain assets; (4) subtract 50 percent of net federal income taxes paid; (5) add certain amounts relating to depreciable assets shown on the federal return; (6) subtract targeted job credits granted on the federal return; (7) subtract certain alcohol fuel credits allowed on the federal return; (8) add certain amounts deducted on the federal return for sale-leaseback agreements; and (9) add the windfall profits tax determined on the federal return. Iowa Code § 422.35 (1983).[24] (Iowa now requires 14 adjustments to federal taxable income. Iowa Code § 422.35 (1990 & Supp. 1991).) In addition, as noted earlier, Iowa did not (and still does not) allow a recipient of foreign subsidiary dividends to claim a foreign tax credit, whether or not one is claimed for federal purposes. It does, however, adjust for the "gross up" amount if such a credit is claimed on the federal return.

[24] Iowa's first adjustment recognizes that "administrative convenience" cannot override other constitutional limitations. By requiring the subtraction of interest and dividends from federal securities, Iowa observes the doctrine of intergovernmental immunity, founded upon the "Borrowing" and "Supremacy" Clauses, *Society For Savings* v. *Bowers*, 349 U.S. 143, 144 (1955), citing, *Weston* v. *Charleston*, 27 U.S. 449 (1829), and codified by Congress, 31 U.S.C. § 3124 (1988), which limits a state's power to tax income from federal securities.

It is obvious from the fact and nature of Iowa's adjustments that something more is involved in preparing an Iowa return than having the taxpayer "merely lift the figures off the federal return." (Pet. App. 9a) The varied and complex adjustments required by Iowa undoubtedly cause taxpayers to spend time and money in tax preparation. They also undoubtedly require the state to incur particular costs in the administration of its system to verify the adjustments made. The Iowa taxing system is in reality something of a hodge-podge that is anything but convenient.

While Iowa relies on federal taxable income as the starting point for its tax base calculations, it makes adjustments to the federal system whenever and wherever its purposes are suited. In light of the multiplicity of adjustments that the state legislature requires and the simplicity of subtracting foreign subsidiary dividends from the tax base in order to eliminate the present discrimination, Iowa's decision to tax foreign subsidiary dividends but not domestic subsidiary dividends as part of its "selective" incorporation of federal figures must be seen as "wholly arbitrary" under the circumstances. *New Orleans* v. *Dukes*, 427 U.S. 297, 303-304 (1976).

In *Lehnhausen* v. *Lake Shore Auto Parts, Inc.*, 410 U.S. 356 (1973), this Court reiterated the dictum that in an Equal Protection dispute not involving fundamental rights, the burden was on the challenger "to negative every conceivable basis" for the challenged classification. *Id.* at 364. By altering the calculation of federal taxable income in numerous ways to ac-

commodate its own interests, Iowa has acted in a manner that is totally inconsistent with the one justification it has offered in support of the discrimination in question. As a result, the only "conceivable basis" for its classification of dividend income has clearly been "negatived" by Iowa itself.

CONCLUSION

For all of the foregoing reasons, the decision of the Supreme Court of Iowa should be reversed.

Respectfully submitted,

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APPENDIX

APPENDIX A

RULE 29.1 STATEMENT

The subsidiaries of petitioner other than wholly-owned subsidiaries are as follows:

464088 Ontario Ltd.
Abal Hermanos S.A.
AGF SP Inc.
Ajinomoto GF, Inc.
Artes Graficas Unidas S.A.
Australian Dried Fruit Agency
Bell Pack, Inc.
C.A. Tabacalera Nacional
Cafe Grand Mere
Cerveceria Nacional Dominicana C. Por A.
Ceylon Tobacco Company Limited
CIA Inversiones Puerto Plata S.A.
Cigarros La Tabacalera Mexicana S.A. de C.V.
Colombina General Foods S.A.
Comptoir de La Confiserie SNC
Confederation of European Community Cigarette Manufacturer's Ltd.
Constellation
Crippa e Berger Fonti Levissima
Dairy Industries Ltd.
Dairy Industries (Jamaica) Ltd.
Dong Mei Food Company Ltd.
Dong Suk Foods Corporation
Dong Suk Ginseng
Don Suk Oil & Fats Co. Inc.
E. Leon Jimenes C. Por A.
Egri Dohanygyar KFT
Fabrica de Cigarillos El Progresso S.A.
Fattorie Osella S.P.A.
Galas de Mexico S.A. de C.V.
General Foods de Colombia
Godfrey Phillips India, Limited

Grundtuck Sgemeinschaft Jacobs Suchard
Guangtong Food Company Ltd.
Hamni Bank
Hostess Frito-Lay
Industria Licorera Hispanoamericana S.A.
Industrias Del Tabaco Alimentos y Bebidas S.A.
International de Vinos, S.A.
International Pet Foods Ltd.
International Tobacco Company Limited
ION S.A.
Jacobs Suchard Budapest GMBH
Kibon S.A.
Korea First Advertising Co. Ltd.
Kotharigf Corp. Ltd.
Kotsiopouli Bros.
L.W. de Mexico S.A. de C.V.
LACTA S.A.
Massalin Particulares S.A.
Maxpax S.A.
Mendiola y Compania, S.A.
Negroni Holding 93
O'Refresko S.A.
Oscar Mayer Cp. Co. Ltd.
Philip Morris Espana S.A.
Philip Morris Sabanci Sigara ve Tutunculuk Sanayi ve Ticaret A.S.
Pietro Negroni Deutschland GmGH
Pietro Negroni France S.A.
Pietro Negroni S.R.L.
Premier Foods Corp.
Prima Meat Packers, Ltd.
Premier Tobacco Industries Limited
Proveedora Ecuatoriana S.A.
Pusan Insurance
Rothman, Benson & Hedges Inc.
Rothman's (UK) Limited
Sam Kwang Glass Co.

SICMA
Sociedad Agricola Comercial Ecuatoriana
Societa di Decaffeinizzazione
Societe Immobilere du 283 Rue de Rosny
Sorcal Comercia di Alimenticos LTDA
Sorvetes e Produtos Alimenticos do Mordests S.A.
Sparkle CP Ltd.
Tabacalera Andina S.A.
Tabacalera Centroamericana S.A.
Tabacalera Costarricense, S.A.
Tabacalera de El Salvador S.A. de C.V.
Tabacalera Nacional, S.A.
Tabacos Norte S.A.
Tabamark S.A.
Tabamax S.A.
Taloca y CIA LtdA
TianMei Food Company Ltd.
Vincenzi Biscotti S.P.A.
Yoplait Italia S.P.A.

APPENDIX B

61. Gross Income Defined.

(a) General Definition

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

78. Dividends Received from Certain Foreign Corporations by Domestic Corporations Choosing Foreign Tax Credit.

If a domestic corporation chooses to have the benefits of subpart A of part III of subchapter N (relating to for-

eign tax credit) for any taxable year, an amount equal to the taxes deemed to be paid by such corporation under section 902(a) (relating to credit for corporate stockholder in foreign corporation) or under section 960(a)(1) (relating to taxes paid by foreign corporation) for such taxable year shall be treated for purposes of this title (other than section 245) as a dividend received by such domestic corporation from the foreign corporation.

164. Taxes.

(a) General Rule

Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

* * *

(3) State and local, and foreign, income, or profits, and excess taxes.

* * *

(b) Definitions of special rules. For purposes of this section—

* * *

(3) Foreign Taxes. A foreign tax includes only a tax imposed by authority of a foreign country.

* * *

APPENDIX C

422.35 Net income of corporation - how computed.

The term **"net income"** means the taxable income before the net operating loss deduction, as properly computed for federal income tax purposes under the Internal Revenue Code, with the following adjustments:

1. Subtract interest and dividends from federal securities.

2. Add interest and dividends from foreign securities, from securities of state and other political subdivisions, and from regulated investment companies exempt from federal income tax under the Internal Revenue Code.

3. Where the net income includes capital gains or losses, or gains or losses from property other than capital assets, and such gains or losses have been determined by using a basis established prior to January 1, 1934, an adjustment may be made, under rules and regulations prescribed by the director, to reflect the difference resulting from the use of basis of cost or January 1, 1934, fair market value, less depreciation allowed or allowable, whichever is higher. Provided that the basis shall be fair market value as of January 1, 1955, less depreciation allowed or allowable, in the case of property acquired prior to that date if use of a prior basis is declared to be invalid.

4. Subtract fifty percent of the federal income taxes paid or accrued, as the case may be, during the tax year, adjusted by any federal income tax refunds; and add the Iowa income tax deducted in computing said taxable income.

5. Subtract the amount of the jobs tax credit allowable for the tax year under section 51 of the Internal Revenue Code to the extent that the credit increased federal taxable income.

6. If the taxpayer is a small business corporation, subtract an amount equal to sixty-five percent of the wages paid to individuals, but not to exceed twenty thousand dollars per individual, named in paragraphs "a", "b" and "c" who were hired for the first time by the taxpayer during the tax year for work done in this state:

a. A handicapped individual domiciled in this state at the time of the hiring who meets any of the following conditions:

(1) Has a physical or mental impairment which substantially limits one or more major life activities.

(2) Has a record of that impairment.

(3) Is regarded as having that impairment.

b. An individual domiciled in this state at the time of the hiring who meets any of the following conditions:

(1) Has been convicted of a felony in this or any other state or the District of Columbia.

(2) Is on parole pursuant to chapter 906.

(3) Is on probation pursuant to chapter 907, for an offense other than a simple misdemeanor.

(4) Is in a work release program pursuant to chapter 246, division IX.

c. An individual, whether or not domiciled in this state at the time of the hiring, who is on parole or probation and to whom the interstate probation and parole compact under section 907A.1 applies.

This deduction is allowed for the wages paid to the individuals successfully completing a probationary period named in paragraphs "a", "b", and "c" during the twelve months following the date of first employment by the taxpayer and shall be deducted in the tax years when paid.

For purposes of this subsection, "physical or mental impairment" means any physiological disorder or condition, cosmetic disfigurement, or anatomical loss affecting one or more of the body systems or any mental or psychological disorder, including mental retardation, organic brain syndrome, emotional or mental illness and specific learning disabilities.

6A. If the taxpayer is a business corporation and does not qualify for the adjustment under section 422.35, subsection 6, subtract an amount equal to sixty-five percent of the wages paid to individuals, but shall not exceed twenty thousand dollars per individual, named in paragraphs "a" and "b" who were hired for the first time by the taxpayer during the tax year for work done in this state:

a. An individual domiciled in this state at the time of the hiring who meets any of the following conditions:

(1) Has been convicted of a felony in this or any other state or the District of Columbia.

(2) Is on parole pursuant to chapter 906.

(3) Is on probation pursuant to chapter 907, for an offense other than a simple misdemeanor.

(4) Is in work release program pursuant to chapter 246, division IX.

b. An individual, whether or not domiciled in this state at the time of the hiring, who is on parole or probation and to whom the interstate probation and parole compact under section 907A.1 applies.

This deduction is allowed for the wages paid to the individuals successfully completing a probationary period named in paragraphs "a" and "b" during the twelve months following the date of first employment by the taxpayer and shall be deducted in the tax years when paid.

The department shall develop and distribute information concerning the deduction available for businesses employing persons named in paragraphs "a" and "b".

7. Subtract the amount of the alcohol fuel credit allowable for the tax year under section 40 of the Internal Revenue Code to the extent that the credit increased federal taxable income.

8. Add the amounts deducted and subtract the amounts included in income as a result of the treatment provided sale-leaseback agreements under section 168(f)(8) of the Internal Revenue Code for property placed in service by the transferee prior to January 1, 1986 to the extent that the amounts deducted and the amounts included in income are not otherwise deductible or included in income under the other provisions of the Internal Revenue Code as amended to and including December 31, 1985. Entitlement to depreciation on any property involved in a sale-leaseback agreement which is placed in service by the transferee prior to January 1, 1986 shall be determined under the Internal Revenue Code as amended to and including December 31, 1985, excluding section 168(f)(8) in making the determination.

9. Add the amount of windfall profits tax deducted under section 164(a) of the Internal Revenue Code.

10. Add the percentage depletion amount determined with respect to an oil, gas, or geothermal well using methods in section 613 of the Internal Revenue Code that is

in excess of the cost depletion amount determined under section 611 of the Internal Revenue Code.

11. If after applying all of the adjustments provided for in this section and the allocation and apportionment provisions of section 422.33, the Iowa taxable income results in a net operating loss, such net operating loss shall be deducted as follows:

a. The Iowa net operating loss shall be carried back three taxable years or to the taxable year in which the corporation first commenced doing business in this state, whichever is later.

b. The Iowa net operating loss remaining after being carried back as required in paragraph "a" of this subsection or if not required to be carried back shall be carried forward fifteen taxable years.

c. If the election under section 172(b)(3)(C) of the Internal Revenue Code is made, the Iowa net operating loss shall be carried forward fifteen taxable years.

d. No portion of a net operating loss which was sustained from that portion of the trade or business carried on outside the state of Iowa shall be deducted.

e. The limitations on net operating loss carryback and carryforward under sections 172(b)(1)(M) and 172(m) of the Internal Revenue Code shall apply.

Provided, however, that a corporation affected by the allocation provisions of section 422.33 shall be permitted to deduct only such portion of the deductions for net operating loss and federal income taxes as is fairly and equitably allocable to Iowa, under rules prescribed by the director.

12. Subtract the loss on the sale or exchange of a share of a regulated investment company held for six months or

less to the extent the loss was disallowed under section 852(b)(4)(B) of the Internal Revenue Code.

13. Subtract the interest earned from bonds and notes issued by the agricultural development authority as provided in section 175.17, subsection 10.

14. Add the expenses otherwise deductible under section 162(a) of the Internal Revenue Code which were incurred by a corporation with respect to expenditures made at, or payments made to, a club which restricts membership or the use of its services or facilities on the basis of age, sex, marital status, race, religion, color, ancestry or national origin.

A club described in this subsection holding an alcoholic beverage license pursuant to chapter 123 shall provide on each receipt furnished to a taxpayer a printed statement as follows: "The expenditures covered by this receipt are nondeductible for state income tax purposes."

For the purposes of this subsection, a club means any nonprofit corporation or association of individuals, which is the owner, lessee, or occupant of a permanent building or part of a building, membership in which entails the prepayment of regular dues, and which is not operated for a profit other than such profits as would accrue to the entire membership.

(11)

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In The

Supreme Court of the United States

October Term, 1991

KRAFT GENERAL FOODS, INC.
(formerly KRAFT, INC.),

Petitioner,

vs.

IOWA DEPARTMENT OF REVENUE AND FINANCE,

Respondent.

On Writ Of Certiorari To The
Supreme Court Of Iowa

BRIEF FOR RESPONDENT

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QUESTIONS PRESENTED

1. Whether the Iowa Business Tax on Corporations, which adopts federal "taxable income" as the starting point for determining the apportionable "net income," thereby treating dividends from domestic and foreign subsidiaries differently, is constitutional under the Commerce Clause.

2. Whether Iowa's treatment of dividends for the Iowa Business Tax on Corporations is valid under the Equal Protection Clause because it is rationally related to legitimate state purposes.

3. Whether, if the Iowa tax law is held to be unconstitutional, the case should be remanded to the Iowa Supreme Court for determination of whether this Court's holding must be retroactively applied and whether refunds must be given.

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No. 90-1918

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IOWA DEPARTMENT OF REVENUE AND FINANCE,

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On Writ Of Certiorari To The Supreme Court Of Iowa

BRIEF FOR RESPONDENT

STATUTES INVOLVED

Set forth in the Appendix to this brief are relevant portions of the following statutes which are referred to in the brief but not already included in the Petition Appendix or the Appendix to Petitioner's brief: Iowa Code §§ 422.32(6) and 422.32(7) (1991), § 422.32(4) (1958), § 422.3(5) (1989); 26 U.S.C. §§ 882(a), 991, and 995(a) as in effect in 1981; 26 U.S.C. § 921(a) (1988), and 26 U.S.C. § 245(c)(1) (1988).

STATEMENT OF THE CASE

The Respondent, Iowa Department of Revenue and Finance (Department), accepts Petitioner's (Kraft's) statement of the case as substantially correct. The Department does *not*, however, accept the argumentative conclusions (at pages 7-8 of Kraft's brief) regarding the tax burden on, and discrimination against, a corporation which receives dividends from a foreign subsidiary. Also, the Department notes the following additional facts.

Iowa imposes an income tax on all corporations incorporated in Iowa and all corporations doing business in Iowa. Iowa Code § 422.33 (1991).[1] The tax is imposed upon corporate "net income" attributable to Iowa. "Net income" is defined as "the taxable income before the net operating loss deduction, as properly computed for federal income tax purposes under the Internal Revenue

---

[1] References to the Iowa Code will be to the 1991 Code, unless otherwise indicated, since there is no material difference between those Code provisions and the provisions applicable to Kraft's 1981 tax year. The use of the term "foreign corporation" in § 422.33 should not be confused with the use of that term in the Internal Revenue Code and in the Stipulation. In § 422.33, a foreign corporation is any corporation organized under law other than Iowa law. *See* Iowa Code § 422.32(3). Also, the term "domestic corporation" in the Stipulation and Internal Revenue Code does not have the same meaning as it does in Iowa Code § 422.32(2) where it means any corporation organized under Iowa law. In this brief, "foreign corporation" and "domestic corporation" have the same meanings as in the Internal Revenue Code. A corporation incorporated in the United States is a domestic corporation, and a corporation organized in a foreign country is a foreign corporation.

Code," with certain adjustments, none of which mention foreign subsidiary dividends. Iowa Code § 422.35. (Stip. ¶ 14, Pet. App. 32a)

In imposing its income tax, Iowa divides the net income into two types. Iowa Code § 422.33(2)(a) provides for an allocation of "nonbusiness income," as defined in Iowa Code § 422.32(7). This type of income, which is not subject to formula apportionment, is not earned in the taxpayer's unitary business. Foreign subsidiary dividends which are nonbusiness income are wholly allocated to the corporation's commercial domicile. The other type of income is "business income," as defined in Iowa Code § 422.32(6). Business dividends are derived from the taxpayer's unitary business and are apportioned within and without Iowa under rules adopted by the Director of the Iowa Department of Revenue and Finance. Iowa Code § 422.33(2)(b)(1).

Dividends, whether declared by a domestic subsidiary or a foreign subsidiary, are declared and payable from the earnings of the subsidiary. (Pet. App. 41a)

Kraft concedes that the foreign subsidiary dividends which were paid to it constituted unitary business income and, under the Iowa Code, are included in Kraft's preapportioned net income base. (Stip. ¶ 20, Pet. App. 33a)

Domestic dividends that satisfy the various conditions imposed by the Internal Revenue Code (IRC) are deductible for federal income tax purposes. 26 U.S.C. §§ 243-246. Therefore, because "net income" in Iowa Code § 422.35 is based on federal taxable income, certain domestic dividends are deductible for Iowa income tax purposes.

Had Kraft's foreign subsidiaries been domestic corporations conducting their businesses exclusively in the foreign countries, the dividends that they declared to Kraft would, under authority of the Internal Revenue Code (IRC), have been deducted in determining Kraft's federal taxable income and, therefore, in determining "net income" for Iowa income tax purposes. (Stip. ¶ 21, Pet. App. 33a)

In 1981, the IRC permitted a domestic corporation that received nondeductible dividends from foreign corporations to claim a federal income tax credit for a portion of the income and certain other taxes paid by the dividend payors to foreign governments and for a portion of any foreign income taxes paid by the dividend payee with respect to the dividend. Alternatively, the dividend payee was allowed to claim as a deduction on its federal income tax return the foreign income taxes withheld with respect to the dividends it received from foreign corporations. (Stip. ¶ 13, Pet. App. 31a)

Iowa does not allow a foreign tax credit. (Stip. ¶ 15, Pet. App. 32a) If, however, a taxpayer elected to deduct foreign taxes to determine federal taxable income, it would also deduct such taxes to calculate Iowa Code § 422.35 net income.

In the Polk County District Court, the only prongs of the Commerce Clause test argued by Kraft were the discrimination and multiple taxation prongs. (Pet. App. 11a-23a) Kraft abandoned the issue of an alleged unconstitutional interference by Iowa with United States foreign policy.

The District Court, in addition to what is noted in Kraft's Statement, found that Kraft had "not shown that the Iowa tax exerts a pressure on interstate business to conduct more of its activities in Iowa." (Pet. App. 17a)

In the Iowa Supreme Court, Kraft abandoned the multiple taxation question. The only Commerce Clause issue presented to the Iowa Supreme Court was whether the Iowa corporate income tax structure unconstitutionally discriminates against foreign commerce. (Pet. App. 5a) The Iowa Supreme Court held that there was no unconstitutional discrimination against foreign commerce because there was no showing "that Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme." (Pet. App. 7a)[2]

SUMMARY OF ARGUMENT

Kraft could do business in foreign countries through domestically incorporated subsidiaries. Dividends from those subsidiaries would be deductible domestic dividends. (Stip. ¶ 21, Pet. App. 33a) Therefore, whatever different effect the Iowa tax law has on corporations operating through subsidiaries results solely from differences between the structures of their businesses, not from

[2] Even if the Iowa Supreme Court applied the wrong test in upholding the Iowa tax law, its decision must be affirmed if the law can be upheld on any grounds. *See Dandridge v. Williams*, 397 U.S. 471, 475 n.6 (1970) ("The prevailing party may, of course, assert in a reviewing court any ground in support of his judgment, whether or not that ground was relied upon or even considered by the trial court.").

the location of their commercial activities, and does not constitute discrimination against foreign commerce. *See Amerada Hess Corp. v. N.J. Taxation Div.*, 490 U.S. 66, 78 (1989). The Commerce Clause does not protect "the particular structures or methods of operation in a retail market." *Exxon Corp. v. Gov. of Md.*, 437 U.S. 117, 127 (1978).

If a corporation must operate in a foreign country through a subsidiary organized in that country, it can still easily avoid having its income from that subsidiary included in the Iowa apportionable income. A domestic holding company subsidiary, with no Iowa connection, could hold the stock of the foreign subsidiary, receive the foreign subsidiary dividends, and pass them on to the parent in the form of deductible domestic dividends. The parent could exclude those dividends from its Iowa net income base in the same way as dividends from earnings accrued from activities conducted wholly in the United States. The ease with which corporations can avoid having foreign dividends included in the Iowa tax base shows that the Iowa tax does not burden or discriminate against foreign commerce or violate equal protection.

Iowa adopted federal "taxable income" as the starting point in computing the Iowa apportionable "net income" in order to make the administration and enforcement of the tax manageable. There was no protectionist intent by the Iowa legislature. IRC provisions which apply to the determination of federal "taxable income" include ones which benefit foreign commerce or benefit doing business through foreign subsidiaries. Iowa adopts IRC provisions even when they favor out-of-state commerce or result in less tax revenue for Iowa.

Because of the way in which a corporation's unitary business is taxed, Iowa does not advantage either Iowa or United States activity at the expense of foreign activities. As a unitary business' Iowa activities increase, more of the unitary earnings will be included in Iowa net income. A domestic subsidiary will pay federal income tax on all of its earnings, whereas only the portion of the earnings of a foreign subsidiary operating abroad which are returned to the parent in the form of dividends are subject to federal tax. The more business a corporation does in the United States, the greater its federal income tax liability will be. The Iowa tax law does not divert business from other countries to Iowa or to the United States.

The presumptively valid Iowa tax treatment of dividends is rationally related to legitimate state purposes, thereby satisfying the Equal Protection Clause. Iowa's conformity with federal taxable income determinations is not merely administratively convenient to taxpayers and Iowa, but is crucial for Iowa's ability to properly enforce its tax system. Iowa critically needs to rely upon the federal taxable income concept and Internal Revenue Service federal tax administration, including treatment of dividends.

These concerns with enforcement are not mitigated by Iowa's nine adjustments to federal taxable income. There is no constitutional requirement that a state conform wholly to federal taxable income determinations or to none of them. Moreover, the adjustments are few in comparison to the vast array of complex federal determinations that Iowa utilizes, and most of these adjustments can be verified from the taxpayer's federal return and in federal audits.

This Court should reject an amicus' suggestion that heightened scrutiny, rather than the traditional rational basis analysis proffered by Kraft, must be used to evaluate Kraft's equal protection challenge. Indeed, heightened scrutiny analysis, here, would be contrary to this Court's prior decisions.

ARGUMENT

I. THE IOWA BUSINESS TAX ON CORPORATIONS, WHICH ADOPTS FEDERAL "TAXABLE INCOME" AS THE STARTING POINT FOR DETERMINING THE APPORTIONABLE "NET INCOME," THEREBY TREATING DIVIDENDS FROM DOMESTIC AND FOREIGN SUBSIDIARIES DIFFERENTLY, IS CONSTITUTIONAL UNDER THE COMMERCE CLAUSE.

A state tax will be sustained "against Commerce Clause challenge when the tax is [1] applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). When the state tax is imposed upon foreign commerce, the test includes the four prongs in *Complete Auto* and, in addition, the considerations of "the enhanced risk of multiple taxation" and whether the state tax "prevents the Federal Government from speaking with one voice" in foreign affairs. *Container Corporation v. Franchise Tax Board*, 463 U.S. 159, 185, 193 (1983); *see Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 446, 448 (1979).

The Washington Legal Foundation (WLF), Kraft's amicus, argues (WLF br. at 11) that if the Iowa tax law is allowed to stand, the federal government is not capable of speaking with one voice on the subject of how foreign corporations will be treated in international commerce with this country. The consideration of whether the state tax "prevents the Federal Government from speaking with one voice" in foreign affairs is a prong of the Commerce Clause test separate from the discrimination prong. *Container*, 463 U.S. at 193; *Japan Line*, 441 U.S. at 448. Only the discrimination prong is at issue in this case. Kraft has waived all other prongs. (Pet. App. 5a; Kraft br. at 14).[3]

[3] "[A] state tax at variance with federal policy will violate the 'one voice' standard if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive." *Container*, 463 U.S. at 194. The Court noted in *Container* that the lack of an amicus curiae brief from the Executive Branch in opposition to the state tax was a factor suggesting that the foreign policy of the United States was not seriously threatened by California's taxing scheme. *Id.* at 195-96. In this case, the Executive Branch is filing an amicus curiae brief defending Iowa's tax scheme. Also, over the last fifteen years several bills have been introduced into Congress which would have limited the taxability of foreign dividends for state income tax purposes. *See* H.R. 2940, 100th Cong., 1st Sess. (1987); S. 1974, 99th Cong., 1st Sess. § 2 (1985); H.R. 3243, 98th Cong., 1st Sess. (1983); S. 1225, 98th Cong., 1st Sess. (1983); H.R. 2918, 98th Cong., 1st Sess. (1983); H.R. 1983, 97th Cong., 2d Sess. (1982); S. 655, 97th Cong., 1st Sess. (1981); S. 983, 96th Cong., 1st Sess. § 302 (1979); H.R. 5076, 96th Cong., 1st Sess. (1979); S. 2173, 95th Cong., 1st Sess. § 302 (1977); S. 1245, 93d Cong., 1st Sess. §§ 207 and 208 (1973). None of those bills were enacted. As in *Container*, 463 U.S. at 197, it cannot be concluded that the state tax at issue is preempted by federal law or fatally inconsistent with federal policy.

A. No Burden Is Placed On Foreign Commerce, Because The Difference In Treatment Of Dividends Is Not Based On The Type Or Location Of Commerce.

In analyzing a case under the Commerce Clause, "the State's interest, if legitimate, is weighed against the burden the state law would impose on interstate [or foreign] commerce." *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869, 881 (1985).

The Iowa tax law does not put a burden on foreign commerce. Whatever different effect Iowa's treatment of dividends may have on those doing business in foreign countries through foreign subsidiaries and those doing business in foreign countries through domestic subsidiaries results from differences between the structure of their businesses, not from the location of their activities. The Commerce Clause does not, however, protect "the particular structures or methods of operation in a retail market." *Exxon Corp. v. Gov. of Md.*, 437 U.S. 117, 127 (1978). Kraft could do business in foreign countries through domestically incorporated subsidiaries. Dividends from those subsidiaries would be deductible domestic dividends. (Stip. ¶ 21, Pet. App. 33a)

Kraft and its amici constantly refer to "foreign source" dividends as being included in the Iowa tax base. That is an inaccurate characterization of those dividends which are included in the apportionable tax base. Dividends from a subsidiary incorporated in the United States could be "foreign source," in that they are paid from foreign earnings, but not be in the Iowa apportionable net income.

In *Amerada Hess Corp. v. N.J. Taxation Div.*, 490 U.S. 66 (1989), oil companies unsuccessfully claimed that the lack of a deduction for the windfall profits tax from "net income" for state income tax purposes violated the Commerce Clause by discriminating against interstate commerce. In responding to the claim that the provision discriminated against oil producers who market their oil in favor of independent retailers who do not produce oil, the Court stated:

> But whatever disadvantage this deduction denial might impose on integrated oil companies does not constitute discrimination against interstate commerce. Appellants operate both in New Jersey and outside New Jersey. Similarly, nonproducing retailers may operate both in New Jersey and outside the State. Whatever different effect the add-back provision may have on these two categories of companies *results solely from differences between the nature of their businesses, not from the location of their activities.*

490 U.S. at 78 (emphasis added). Whatever different effect the Iowa tax law has on corporations operating through unitary subsidiaries does not result from differences in the location of their commercial activities. A domestic subsidiary's commercial activities could be located in foreign countries.

In *Exxon v. Gov. of Md.*, 437 U.S. 117 (1978), "Exxon and other integrated companies could find no warrant in the Commerce Clause to operate in an integrated form within Maryland's retail gasoline market." Laurence H. Tribe, *American Constitutional Law* 25 (Supp. 1979). Similarly, Kraft and other multinational corporations can find

no warrant in the Commerce Clause to operate in foreign countries through foreign corporations rather than domestic corporations.

If a foreign country requires Kraft to do business there only through a company incorporated in that country, or Kraft for other reasons prefers to do business there through a foreign subsidiary, Kraft can still easily avoid having income attributable to its foreign operations included in its Iowa apportionable net income. Kraft could easily, as several multinational corporations have done, set up a domestic holding company to hold the stock of the foreign subsidiary. The holding company could have no function other than to hold the stock of the foreign subsidiaries, receive the foreign dividends and pass them on to its parent, Kraft, in the form of domestic dividends. Those dividends paid to Kraft by the domestic holding company would be deductible to the same extent as dividends from any other 100% owned domestic subsidiary. The holding company would not need to do any business in Iowa, and so would not be subject to the Iowa income tax. The holding company's income would not be included in the Iowa apportionable base, because Iowa has separate reporting, rather than combined reporting such as in *Container Corporation v. Franchise Tax Board*, 463 U.S. 159 (1983).

In *Regan v. Taxation With Representation*, 461 U.S. 540 (1983), the Court found that an IRC provision prohibiting substantial lobbying on the part of organizations qualifying to receive tax deductible contributions did not violate the First Amendment. The Court noted that the organization could set up a separate organization to do its lobbying. *Id.* at 544. The IRS required "only that the two groups

be separately incorporated and keep records adequate to show that tax-deductible contributions are not used to pay for lobbying." *Id.* at 544 n.6. That requirement was "not unduly burdensome." *Id.* Similarly, establishing a domestic holding company is not unduly burdensome.

The fact that corporations can so easily avoid having foreign dividends included in their apportionable income, without giving up their foreign operations, shows that the Iowa tax law does not burden or discriminate against foreign commerce. The Court has stated that discrimination "is a practical conception" and the Court "must deal in this matter, as in others, with substantial distinctions and real injuries." *Gregg Dyeing Co. v. Query*, 286 U.S. 472, 481 (1932).

B. Iowa Has Not Adopted The Internal Revenue Code Treatment Of Dividends In Order To Be Protectionist, But Because It Has A Substantial Legitimate Interest In Coupling With The IRC.

In 1955, Iowa Code section 422.35 was amended to couple the Iowa business tax on corporations to the Internal Revenue Code (IRC). The amendment defined "net income" to mean "the taxable income less the net operating loss deduction, both as computed for federal income tax purposes under the Internal Revenue Code of 1954, with the following adjustments:. . . . " 1955 Iowa Acts, ch. 208, § 19 (H.F. 225, 56th G.A.). The definition of "Internal Revenue Code of 1954" was routinely amended each year to include any amendments made to the IRC. *See, e.g.*, Iowa Code § 422.32(4) (1958). After the Tax Reform Act of

1986, Iowa Code § 422.35 referred to the "Internal Revenue Code," which means "the Internal Revenue Code of 1954, prior to the date of its redesignation as the Internal Revenue Code of 1986 by the Tax Reform Act of 1986, or means the Internal Revenue Code of 1986 as amended . . . whichever is applicable." *See, e.g.*, Iowa Code § 422.3(5) (1989).

In order to find that Iowa treats foreign subsidiary dividends differently than domestic subsidiary dividends, one must look at the IRC provisions regarding dividends. This is not a case where foreign subsidiary dividends were singled out for a deduction denial. In *Amerada Hess v. N.J. Taxation Div.*, 490 U.S. 66, 77 (1989), the Court pointed out that the add-back provision at issue there "[did] not single out the windfall profit tax for a deduction denial" and that the Court did not need to consider whether a statute that did so would impermissibly discriminate against interstate commerce. Amendments to the IRC are adopted by the Iowa legislature regardless of whether they favor one type of commerce over another. The State accepts IRC exemptions and deductions, even when it means less tax will be paid to Iowa. There was no intent by the Iowa legislature to favor interstate commerce over foreign commerce or even to treat corporations differently based on the source of their dividend income.[4]

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[4] Considering all IRC provisions adopted by Iowa, it is possible that foreign commerce is favored over interstate commerce. "A great portion of the wealth owned by United States corporations is derived from business operations in foreign

(Continued on following page)

Iowa has not incorporated the IRC provisions into § 422.35 in order to be protectionist. It has adopted the federal "taxable income" concept in order to make the administration of the business tax manageable and to maximize taxpayer convenience and ease in complying with the Iowa tax laws. The Department can rely on IRS audits of taxpayers and judicial opinions interpreting the IRC. Using the federal taxable income figure allows the taxpayer "to merely lift the figures off the federal return and transfer them to the Iowa [income] tax return. The Department of Revenue receives the benefit of the regulations and interpretations of the federal agency." *First*

(Continued from previous page)

countries." Jasper G. Taylor III, *The Foreign Tax Credit, Deferral, and the DISC Provisions: Casualties in a Holy War of Protectionism?*, 16 Houston L. Rev. 63, 63 (1978). One reason for the substantial foreign investment by United States corporations is the fact that the United States does not tax the earnings of United States shareholder-controlled foreign corporations until, with some exceptions, those earnings have been distributed to the United States shareholders. *Id.* This "deferral", as it is often called, allows the foreign corporation to reinvest all of its earnings if it so desires, thereby expanding its foreign operations. *Id.* at 63-64. "The tax benefits that arise from deferral are obvious. In some cases, deferral is tantamount to an exclusion from taxation, since foreign earnings are often never repatriated." *Id.* at 81.

There are several federal tax factors to be considered in choosing the form through which a foreign business venture is to be conducted. Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 17.10, at 17-29 (4th ed. 1979). "[I]t is ordinarily advantageous to a taxpayer whose business activities give rise to foreign-source income to have such business classified as a 'foreign' person. . . . " *Id.* at 17-28.

National Bank of Ottumwa v. Bair, 252 N.W.2d 723, 726 (Iowa 1977). The use of the federal taxable income figure avoids carrying out "complex procedures in computing the Iowa tax, involving the time and expense required to complete federal returns" by taxpayers. *Id.* The coupling of Iowa net income in § 422.35 with federal taxable income "is done for the convenience of the taxpayer, as a savings to the State, and to provide the State with a means of verifying the accuracy and honesty of a taxpayer's return." *Getty Oil Co. v. Taxation & Rev. Dept.*, 93 N.M. 589, 592, 603 P.2d 328, 331 (Ct. App. 1979).

The fact that the IRC allows a foreign tax credit does not mean that Iowa must also allow the credit. "The federal credit would have already vindicated the goal of not subjecting the taxpayer to a higher tax burden that (sic) it would have to bear if its subsidiary's income were not taxed abroad." *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 191 n.30 (1983). There is no logical reason why a state would have to grant another credit of its own. *Id.* If Iowa followed the IRC with regard to the foreign tax credit, each dollar of foreign tax would result in a total of two dollars of credit in the United States. Also, the IRC credit provisions cannot be adopted without change. The federal credits, which apply to federal tax due on the total federal taxable income, could wipe out the Iowa tax liability. The foreign tax credit, for example, allows a credit for foreign taxes attributable to all of the foreign source income taxed by the IRC, not just for taxes attributable to the foreign subsidiary dividends apportioned to Iowa by Iowa's apportionment formula.

Kraft and its amici argue that it would be easy for the State of Iowa to add an adjustment to Iowa Code § 422.35

which would subtract from the federal "taxable income" figure the dividends from foreign subsidiaries. They fail to consider that by adopting federal "taxable income" as the starting point in computing the Iowa apportionable "net income," Iowa adopted all provisions of the IRC which apply to the determination of federal "taxable income," including IRC provisions which benefit only companies doing foreign commerce or only companies doing commerce through foreign subsidiaries.[5] If Iowa is required to decouple from IRC provisions giving domestic subsidiary dividends favorable treatment, it would presumably also have to decouple from IRC provisions

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[5] For example, in 1981, the year at issue, IRC provisions regarding Domestic International Sales Corporations (DISCs) were intended to "provide an inducement for increasing exports and . . . a means of removing discrimination against those who export through U.S. corporations." S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971). A DISC allows large corporations to defer taxation on a portion of their export profits indefinitely. Phillip L. Jelsma, Note, *The Making of a Subsidy, 1984: The Tax and International Trade Implications of the Foreign Sales Corporation Legislation*, 38 Stan. L. Rev. 1327, 1332-33 (1986); *see* 26 U.S.C. §§ 991-997.

Amendments to the IRC effective for transactions after 1984 authorize the establishment of a system of foreign sales corporations (FSCs). A portion of the foreign trade income of a FSC is exempt from tax at the corporate level, provided it is derived from the foreign presence and economic activity of the FSC. *See* 26 U.S.C. §§ 921-927 (1988). The dividends paid by a FSC to a United States corporate shareholder from export income are tax-exempt at the corporate-shareholder level. 26 U.S.C. § 245(c) (1988); 47A C.J.S. *Internal Revenue* § 442(1), at 851 (1991). Although the FSC provisions were not in effect during the year at issue, 1981, they illustrate how IRC provisions may benefit only one type of commerce.

that benefit only foreign commerce or doing business through foreign subsidiaries. So many adjustments to federal "taxable income" could be required that the benefits of coupling with the IRC would no longer exist. Also, if states have to scrutinize all IRC provisions and future amendments to determine whether they favor one type of commerce over another, it will no longer be convenient for states to couple with the IRC. Decoupling from the federal tax system will be disadvantageous to taxpayers as well as to the states.

As discussed in the prior section of this brief, the Iowa tax law does not impose a burden on foreign commerce. As shown in this section of the argument, and discussed to a greater extent in Division II regarding the Equal Protection Clause, the State's interest in coupling with the IRC is legitimate and substantial. Therefore, the Iowa statute, § 422.35, does not violate the Commerce Clause. *See Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869, 881 (1985) ("Under Commerce Clause analysis, the State's interest, if legitimate, is weighed against the burden the state law would impose on interstate commerce.").

C. Iowa Taxes The Total Unitary Business' Income In A Way Which Does Not Favor Any Local Iowa Activity Or United States Activity At The Expense Of Foreign Activities.

Because of the way in which a corporation's unitary business is taxed, Iowa does not encourage, protect, or otherwise advantage Iowa, *or United States*, activities at the expense of foreign activities. Indeed, the opposite is generally true.

Dividends payable to Kraft or any other parent corporation are paid from the subsidiary's earnings. (Pet. App. 41a) The unitary subsidiary, whether foreign or domestic, is merely an extension of the parent corporation's overall unitary business. *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980); (Pet. App. 30a, Stip. ¶ 10).

If the parent corporation subject to Iowa tax has a wholly owned unitary foreign subsidiary located solely in a foreign country, Iowa would include in apportionable net income only a portion of the subsidiary's earnings, as represented by dividends paid to the parent. Those dividends are less than the total earnings that would be taxed by Iowa if the subsidiary were a domestic subsidiary wholly located in Iowa. They are also less than the earnings of a wholly owned domestic subsidiary which are included in net income if the subsidiary does a portion of its business in Iowa. More earnings of the domestic subsidiary, which has income producing activities in Iowa, than earnings of the foreign subsidiary, which has no Iowa activities, are included in the preapportioned net income base for the unitary business as a whole.

If the wholly owned unitary domestic subsidiary does no business in Iowa, the dividends paid by it are not in the parent's preapportioned net income base, and its earnings are not taxed by Iowa. Yet, here again, Iowa activities are not encouraged, protected, or otherwise advantaged in comparison to out-of-state activities. The treatment of dividends does not encourage a parent to locate a subsidiary's activities in Iowa. The opposite is

true, because if either a domestic or foreign subsidiary were located in Iowa, Iowa's tax on the unitary earnings would likely increase. As a unitary business' Iowa activities increase, more of the unitary earnings will be included in Iowa net income, resulting in greater taxation of those earnings.[6] There is no direct commercial advantage to local Iowa business at the expense of non-Iowa business.

There is also no direct commercial advantage to United States business at the expense of foreign business. If the foreign subsidiary did business in the United States, it would be subject to federal income tax on the portion of its earnings effectively connected with the trade or business in the United States. 26 U.S.C. § 882(a); Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 17.04, at 17-22 (4th ed. 1979).

The example set forth at pages 14-15 of the WLF brief compares the treatment of dividends from a domestic corporation doing half of its business in Iowa with the treatment of dividends from a foreign corporation doing half of its business in Iowa and the other half in a foreign country. WLF fails to point out that the foreign subsidiary will pay federal income tax on only the portion of its earnings effectively connected with its business in Iowa, whereas the domestic subsidiary will pay federal tax on all of its earnings. Further, as discussed previously, the

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[6] The Commerce Clause "is not designed to protect local commerce." Philip M. Tatarowicz & Rebecca F. Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 Vand. L. Rev. 879, 926 (May 1986).

difference in the treatment of dividends is not based on whether foreign operations are conducted, but merely on where the subsidiary is organized.

The Iowa tax law does not favor domestic commerce over foreign commerce. Clearly, the more business that a corporation does in the United States, the greater its federal tax liability will be. Every corporation subject to the Iowa tax will be subject to the federal tax, and the amount of Iowa "net income" depends upon the amount of federal "taxable income."

There is no proof that a company operating in interstate commerce will have less of a tax burden than will a company whose unitary business includes doing business in foreign countries through foreign subsidiaries. If a unitary business confines itself to domestic operations, its unitary income stream could be subjected to greater tax than if it operates in foreign countries.[7] If every state adopted the Iowa method of taxation, the unitary earnings of domestic subsidiaries would be subject to state and United States taxation which could be more burdensome than the taxation of the foreign subsidiary earnings.

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[7] A domestic subsidiary's earnings are taxed by the United States Government and, if the subsidiary does business there, by the forty-six states and the District of Columbia which impose taxes on net incomes. Jerome R. Hellerstein, *State Taxation: Corporate Income and Franchise Taxes* ¶ 1.6, at 20-21 (1983). WLF's "simple question" (at p.7 of its brief), which supposedly demonstrates the "fundamental failure" of the Iowa tax, does not address a situation where the earnings from which domestic investment income is paid are taxed by the Federal Government and most states.

This possibility negates any claim that the Iowa tax system discourages investment abroad and protects that in the United States. It also counters the WLF's claim (WLF br. at 6) that the Iowa tax cannot pass the internal consistency test.

Because the Iowa treatment of dividends, within the context of its treatment of unitary earnings, does not favor Iowa or United States activities over those in foreign countries, the Iowa tax structure does not discriminate against foreign commerce in violation of the Commerce Clause.

D. The Iowa Tax Law Does Not Discriminate Against Foreign Products.

Kraft relies upon *Hale v. Bimco Trading, Inc.*, 306 U.S. 375 (1939), which invalidated a Florida law providing for an inspection fee for foreign cement but not for cement produced in the United States. In *Hale*, however, the Court emphasized that local Florida-produced cement was being protected from competition by foreign-produced cement. Also, in *Hale* the purpose of the statute was "to keep out foreign goods." *Id.* at 380. The Iowa statute at issue has neither the purpose nor the effect of favoring Iowa or other American products over foreign products.

The WLF argues that Iowa is effectively imposing a duty on the import of dividends from abroad. (WLF br. at 7-8) The WLF also discusses the Import-Export Clause of the Constitution.[8] (WLF br. at 12) The Import-Export

[8] U.S. Const. art. I, § 10, cl. 2.

Clause is not at issue in this case and should not be considered. Furthermore, the fact that a dividend could be paid in kind, such as in WLF's butter example, rather than in cash, does not change the dividend into a product being imported from abroad or change the tax on Kraft's Iowa income into an impost or duty.

> [I]ncome that is included in the preapportionment tax base is not, by virtue of that inclusion, taxed by the State. Only the fraction of total income that the apportionment formula determines (by multiplying the income tax base by the apportionment fraction) to be attributable to Iowa's taxing jurisdiction is taxed by Iowa.

Shell Oil Co. v. Iowa Department of Revenue, 488 U.S. 19, 30 (1988).

Cook v. Commonwealth of Pennsylvania, 97 U.S. 566 (1878), discussed by Kraft, does not support Kraft's argument. In *Cook*, a Pennsylvania tax was imposed on sales by auctioneers, with an exception for "groceries, goods, wares and merchandise of American growth or manufacture." *Id.* at 569. The tax exemption favored American, including Pennsylvania, enterprises at the expense of foreign businesses. The Court stated that, by way of the Commerce Clause,

> the framers of the Constitution believed that they had sufficiently guarded against the dangers of any taxation by the States which would interfere with the freest interchange of commodities among the people of the different States, and by the people of the States with citizens and subjects of foreign governments.

Id. at 574. The Iowa treatment of dividends does not interfere with the free interchange of commodities among people of different states or by Americans with citizens and subjects of foreign governments. Dividends from subsidiaries are not treated differently based on whether the subsidiaries are selling American or foreign products, or based on where the products are being sold.

II. IOWA'S TREATMENT OF DIVIDENDS DOES NOT DENY PETITIONER EQUAL PROTECTION, BECAUSE IT IS RATIONALLY RELATED TO LEGITIMATE STATE PURPOSES.

Kraft and amicus Avon Products, Inc., et al. (Avon) make several equal protection attacks upon the Iowa tax treatment of dividends. First, Kraft and Avon erroneously urge that no legitimate purpose is served by Iowa's coupling of its net income base to the federal taxable income base which results in the dividend classification at issue. Second, Kraft concedes that such legitimate purpose may exist, but erroneously urges that Iowa's few federal conformity adjustments negate all benefits from conformity so that a legitimate purpose can no longer be found. Third, Avon erroneously urges that the Iowa tax treatment of dividends is subject to a heightened scrutiny.

Various fundamental principles apply in resolving constitutional challenges under the Equal Protection Clause. Where, as here, the challenged tax classification does not adversely affect a fundamental interest and is not based on a suspect criterion, it is tested under only the lenient standard of rationality that is traditionally

applied in evaluating equal protection challenges to regulation of economic and commercial matters. *Exxon Corporation v. Eagerton*, 462 U.S. 176, 195 (1983). Under this standard, a statute will be upheld if the legislature could have reasonably found "that the challenged classification would promote a legitimate state purpose." *Id.*; *see New Orleans v. Dukes*, 427 U.S. 297, 303 (1976); *Regan v. Taxation With Representation of Washington*, 461 U.S. 540, 547 (1983).

The broadest discretion is given to a legislature in creating tax classifications.[9] *Leathers v. Medlock*, 111 S.Ct. 1438, 1446 (1991); *Madden v. Kentucky*, 309 U.S. 83, 87-88 (1940).

> Traditionally classification has been a device for fitting tax programs to local needs and usages in order to achieve an equitable distribution of the tax burden. It has, because of this, been pointed out that in taxation, even more than in other fields, legislatures possess the greatest freedom in classification. Since the members of a legislature necessarily enjoy a familiarity with local conditions which this Court cannot have, the presumption of constitutionality can be overcome only by the most explicit demonstration that a classification is a hostile and oppressive discrimination against particular persons and classes.

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[9] "Given the wide latitude of State legislatures in making tax classifications, comparatively few State taxes have been found repugnant to the Federal constitutional guaranty of equal protection of the laws." Jerome R. Hellerstein, *State Taxation: Corporate Income and Franchise Taxes* ¶ 3.3, at 43 (1983); *see* Paul J. Hartman, *Federal Limitations on State and Local Taxation* § 3:1, at 131 (1981).

Madden, 309 U.S. at 87-88 (footnotes omitted). The *Madden* Court's quoted statement has been consistently adopted by this Court. *Leathers v. Medlock*, 111 S.Ct. 1438, 1446 (1991); *Regan v. Taxation With Representation*, 461 U.S. 540, 547-48 (1983). In selecting subjects for taxation, a legislature "may make distinctions of degree having a rational basis," which "must be presumed to rest on that basis if there is any conceivable state of facts which would support it." *Carmichael v. Southern Coal & Coke Company*, 301 U.S. 495, 509 (1937).

A. Legitimate State Purposes Are Served.

The federal government has opted to include foreign subsidiary dividends in the domestic corporate parent's tax base and to provide a tax credit to alleviate dual taxation by the foreign and federal government. Whether Iowa's coupling of its tax base to federal taxable income[10] lacks a focus on avoiding double taxation is no basis to assert that such coupling does not serve legitimate state purposes. The Iowa Supreme Court properly noted the following legitimate tax policies served by that coupling:

> The coupling of Iowa net income with the federal formula is convenient for the taxpayer, prevents the taxpayer from spending time and money on complex forms, provides a saving to the state, allows the state to rely on federal regulation and interpretation, and provides the

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[10] "The outstanding characteristic of State corporate net income measures is their broad conformity to the measure of the Federal corporation income tax." Hellerstein, *supra* note 9, ¶ 7.2, at 266.

> state with an inexpensive and quick way of verifying the accuracy of taxpayers' returns.

465 N.W.2d at 669. (Pet. App. 10a)

Taxation of income of corporations involves massive and complex determinations and calculations of gross income and deductions, as a cursory reading of the IRC and Internal Revenue Service rules would suggest. Indeed, federal tax treatment of corporate distributions, including dividends, is "a wonderfully complex subject." Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 7.01, at 7-2 (4th ed. 1979). A host of complicated determinations with respect to dividends and corporate distributions exist. *Id.* at ch. 7. Moreover, the "treatment of foreign-source income is a complex subject." *Id.* ¶ 17.01, at 17-2. By coupling Iowa net income determinations with the federal taxable income concept, Iowa and taxpayers need apply only one set of rules that have been established on the federal level. Whether these rules arise from legislative, administrative, or litigated results, acrimony between taxpayers and tax agency as to the make-up of the tax base is significantly reduced, as are the attendant costs to both, because determinations made at the federal level will not be subject to decision anew or conflict with those at the state level.

It is critical to a state's ability to properly administer and enforce an income tax that it be allowed to use federal taxable income determinations. As one commentator noted:

> Even in those States whose laws contain no explicit provision for conformity in implementation, in the actual administration and judicial construction of the State statutes, the practice is

> ordinarily to follow the Federal rules and regulations and to adopt the results of the Federal audit with respect to the common terms incorporated by reference from the IRC, or as set out in the State's own detailed definitions that substantially follow the Federal terminology. Indeed, there is no other viable course, since State tax administrators have neither large enough staffs nor sufficient expertise to perform full-scale independent audits of the books and records of large corporations. Consequently, for all practical purposes, except in unusual circumstances, the State audit of corporate tax returns employing a net income measure begins with Line 28 of the taxpayer's Federal Form 1120, taxable income as determined by the IRS on audit.

Hellerstein, *supra* note 9, ¶ 7.2[5], at 275 (footnotes omitted).

It is clear that Iowa is justified in coupling its income tax base largely to federal taxable income. Otherwise, Iowa could not adequately administer and enforce the tax. Due to Iowa's inability to audit large corporations, taxpayers' initial decisions on determining and reporting corporate net income would, in practice, not be properly subject to review. This problem, more than any other, dictates that Iowa be allowed to conform to the federal taxable income base.

It is no answer to suggest that Iowa could cure the alleged discrimination by simply excluding foreign subsidiary dividends from the tax base. (Kraft br. at 29) First, that exclusion would require a state to expend its small resources on such issues as verifying, without the aid of

federal audits, whether distributions to large corporations were dividends or some other type of income that should be included in the income base. The Internal Revenue Service may be unconcerned with that distinction. Avon trivializes the administrative problems associated with decoupling from the IRC by arguing that the Department need only alter a tax form. (Avon br. at 18) Also, another issue could be verification of the amount of the dividends. The fact that some other states made political decisions to exclude all dividends from their income bases does not demonstrate that their tax administrators can easily administer such exclusions. Dividends are paid from earnings and profits. Computing earnings and profits "is often no simple task." Bittker & Eustice, *supra* ¶ 7.03, at 7-12. Iowa's small audit staff is not sufficient to make these determinations. Second, such a remedy suggests that the "cure" for any disputed income inclusion in a state tax base is merely one of exclusion. But, if that is the cure, the tax base could dissipate away. Third, this "cure" would effectively preclude Iowa from choosing to tax both foreign and domestic subsidiary dividends, an unreasonable result not mandated by the Constitution.

Kraft's argument that the dividend classification at issue violates equal protection even if effected because of difficulties otherwise inherent in the administration and enforcement of the tax cannot be squared with this Court's decision in *Madden v. Kentucky*, 309 U.S. 83 (1940). In *Madden*, the issue was "whether a state statute which imposes on its citizens an annual ad valorem tax on their deposits in banks outside of the state at the rate of fifty cents per hundred dollars and at the same time imposes on their deposits in banks located within the state a

similar ad valorem tax at the rate of ten cents per hundred dollars is obnoxious to the [Equal Protection Clause] of the Fourteenth Amendment." *Id.* at 86. The higher tax upon out-of-state bank deposits than upon in-state bank deposits, if imposed without justification, might have been stricken as "the very sort of parochial discrimination that the Equal Protection Clause was intended to prevent." *See Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869, 878 (1985). However, the State had experienced difficulty in the administration and enforcement of the tax on out-of-state bank deposits, including a problem of concealment. In upholding the classification at issue, this Court noted that "treatment accorded the two kinds of deposits may have resulted from the differences in the difficulties and expenses of tax collection." *Madden*, 309 U.S. at 90.

If Iowa cannot rely upon the concept of federal taxable income and Internal Revenue Service enforcement of that concept, Iowa could conceivably be plagued by enforcement problems, including those due to concealment. If Iowa included domestic subsidiary dividends in the income base, concealment of such dividends would not be of import to the Internal Revenue Service since they are excluded on the federal level. In *Madden*, the state could have solved the problem of the out-of-state bank deposits by not placing them in the tax base, as Kraft and Avon suggest for foreign subsidiary dividends. This drastic measure was not required in *Madden*. It should not be required of Iowa.

Avon relies heavily upon *WHYY v. Glassboro*, 393 U.S. 117, 119 (1968), in which a property tax exemption that was denied to a nonprofit corporation solely on the basis

of the corporation's out-of-state incorporation was held to violate equal protection. (Avon br. at 17-19) While the classification was defended upon grounds of administrative burdens in evaluating a corporation's nonprofit status under other state law, this Court rejected that argument because other states' laws did not need to be considered. The opinion noted that there was no suggestion "that there is any greater administrative burden in evaluating a foreign [non-New Jersey] than a domestic corporation under New Jersey law." *Id.* at 120. This case has no analog to the problems posed if Iowa cannot rely upon federal determinations, including those associated with dividends.

Kraft argues that Iowa's treatment of dividends is similar to an attempt by Iowa to tax all Delaware corporations by apportioning their income as computed under Delaware law while other corporations' apportionable income would be computed under Iowa law. (Kraft br. at 27) Such an attempt by Iowa would not be related to federal taxable income and would be the very "invidious discrimination, the wholly arbitrary act" which violates equal protection guarantees. *New Orleans v. Dukes*, 427 U.S. 297, 303-04 (1976). The federal taxable income and Iowa taxable income concepts are based upon statutes and regulations that are uniformly applicable to all corporations subject to Iowa tax.

B. Iowa's Specific Adjustments To Federal Taxable Income Are Not Inconsistent With The Legitimate Purposes Of Federal Conformity.

Kraft points to nine adjustments in Iowa Code § 422.35 (1983) that it claims undermine the legitimate

purposes inherent in Iowa's federal taxable income conformity for the tax year 1981. (Kraft br. at 28) There is, however, no rigid rule that requires a state to adopt, without modification, the entire federal tax system or none of it.[11] "The most efficient and simplest method of achieving Federal conformity, without complete piggybacking, is to incorporate by reference in the State statute the current key Federal income tax terms, such as 'gross income' and 'taxable income' and then make such specific adjustments as State policy may dictate." Jerome R. Hellerstein, *State Taxation: Corporate Income and Franchise Taxes* ¶ 7.2[1], at 267 (1983). Iowa has adopted this approach. *Id.* at 267 n.19.

Under the logic of Kraft's reasoning, there can never be justification for coupling of state taxable income to federal taxable income to accomplish a legitimate state purpose if the state has enacted a few adjustments to the determination of federal taxable income. No authority supports this novel and unjustified position.

Neither the qualitative nor the quantitative nature of Iowa's nine adjustments require a Court to reject the overall coupling results (or any part of them) on the grounds that they somehow cause this coupling to no longer be rationally related to legitimate state purposes.[12]

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[11] Merely because Congress has elected a policy associated with income at the federal level does not mandate identical treatment by the States. *Mobil Oil Corp. v. Commissioner*, 445 U.S. 425, 448 (1980).

[12] The first adjustment listed by Kraft is for interest and dividends from federal securities. Such income is generally

(Continued on following page)

Within the context of the Iowa law that provides for very few adjustments to federal taxable income in comparison to the vast array of coupling determinations and calculations, it is absurd to suggest that the Iowa tax system has only a remote relationship to federal taxable income.[13]

C. Iowa's Tax Treatment Of Dividends Is Not Subject To A Closer Look Under The Equal Protection Clause.

Avon attempts to alter the issue in this case by arguing that even if the Iowa tax system is valid under a traditional rational basis analysis, this Court should examine the system using a heightened scrutiny analysis because Kraft's claim is based upon alleged discrimination against foreign commerce and because corporations,

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(Continued from previous page)

taxed at the federal level. Iowa must constitutionally exempt such income from Iowa income tax in light of the doctrine of intergovernmental immunity. This doctrine cannot be overridden by an equal protection rational purpose analysis as "it is inappropriate to rely solely on the mode of analysis developed in our equal protection cases" when the issue is intergovernmental immunity. *Davis v. Michigan Department of Treasury*, 489 U.S. 803, 816 (1989).

[13] While the nine adjustments are made to federal taxable income, most of them involve matters which are reported on the federal return and which are subject to audit by the Internal Revenue Service so that Iowa can take advantage of federal determinations to verify and enforce them. It is clear, therefore, that there is no merit to Kraft's claims that the Iowa taxable income concept is a "hodge-podge" and that the Iowa adjustments appreciably add to taxpayers' "time and money in tax preparation." (Kraft br. at 29)

like Kraft, cannot participate in the Iowa political process. (Avon br. at 19-23) Kraft makes no such claim below or here. An amicus cannot alter an issue as presented by the parties and, therefore, this Court should decline to address the equal protection claim under a heightened scrutiny standard.

Even if it is appropriate to consider whether a heightened scrutiny should be made, to do so would be contrary to precedent. This Court has applied a traditional rational basis analysis to evaluate equal protection challenges to taxes where a claim is made of discrimination based upon location or interstate commerce. *Amerada Hess Corp. v. Director, Division of Taxation*, 409 U.S. 66, 80 (1989); *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869, 881 (1985); *Western and Southern Life Insurance Co. v. State Board of Equalization*, 451 U.S. 648, 668 (1981); *Madden v. Kentucky*, 309 U.S. 78, 87-88 (1940). There is no reason to depart from this well-settled mode of constitutional analysis. Avon relies upon dictum in *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356, 359 n.3 (1973). (Avon br. at 19-20) In none of the tax cases cited by Avon was a "closer look," as advocated by Avon, made as opposed to a traditional rational basis analysis.

The Iowa Supreme Court noted that Iowa's dividend classification affected Iowa corporations as well as out-of-state corporations such as Kraft. (Pet. App. 7a-8a) Those Iowa corporations who receive dividends from foreign subsidiaries have access to the political process. Moreover, as Kraft showed, a number of states do exclude foreign subsidiary dividends from the income base, which suggests that there is taxpayer access to the political process. (Kraft br. at 8, n.10) Accordingly, Avon's

essential predicate, namely, that the Iowa political process is never amenable to the affected taxpayers is wrong.

D. Differences In Dividend Treatment Result From Differences In Business Structures Rather Than Location Of Commerce.

If Kraft had conducted its foreign business through a domestic subsidiary, dividends paid by that subsidiary would have been excluded from Kraft's apportionable net income. Kraft could also have created a domestic holding company subsidiary, with no Iowa connection, to own the stock of a foreign subsidiary and to receive the foreign subsidiary dividends. Thereafter, the holding company could pass such income to Kraft in the form of domestic dividends. Those dividends would be excluded from Kraft's apportionable net income in the same way as domestic subsidiary dividends paid from earnings accrued wholly in the United States. These results are consistent with the federal treatment of domestic dividends.

There can be no discrimination against interstate or foreign commerce if different tax treatment "results solely from differences between the nature of their businesses, not from the location of their activities." *Amerada Hess Corp. v. Director, Division of Taxation*, 490 U.S. 66, 78 (1989). That is the situation here.

In *Regan v. Taxation With Representation*, 461 U.S. 540 (1983), in order to qualify to receive tax deductible contributions even while lobbying, an organization could set up a separate organization to do its lobbying. *Id.* at 544. The IRS required "only that the two groups be separately

incorporated and keep records adequate to show that tax-deductible contributions are not used to pay for lobbying." *Id.* at 544 n.6. That requirement was "not unduly burdensome." *Id.* Similarly, the actions which Kraft could take to avoid having its income attributable to its foreign operations included in its apportionable net income are not unduly burdensome.

III. IF IOWA CODE SECTION 422.35 IS HELD TO BE UNCONSTITUTIONAL, THE COURT SHOULD REMAND THE CASE FOR CONSIDERATION OF WHETHER THE HOLDING MUST BE RETROACTIVELY APPLIED AND WHETHER CORPORATIONS' CLAIMS FOR REFUND OF TAX ATTRIBUTABLE TO FOREIGN DIVIDENDS MUST BE GRANTED.

The Department raised as an issue in the lower courts whether a decision finding the Iowa corporate income tax facially unconstitutional can be applied to other taxpayers prospectively only and, if so, the scope of any such prospective ruling. (Pet. App. 23a, 26a, 51a) Evidence relevant to the prospectivity issue was included in the Stipulation. (Pet. App. 43a-50a) Because the courts below held that Iowa Code § 422.35 is constitutional, they did not address the question of refunds or the retroactivity of a holding of unconstitutionality.

In *James B. Beam Distilling Co. v. Georgia*, 111 S. Ct. 2439 (1991), Justice Souter stated that the remand of *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984), for consideration of a defense raised by the state on the question of refunds "could be fairly read" as an implicit ruling by the Court that *Bacchus* applied retroactively. 111 S.Ct. at 2445.

Justice Souter also stated in *Beam* that "[b]ecause the *Bacchus* opinion did not reserve the question whether its holding should be applied to the parties before it, . . . it is properly understood to have followed the normal rule of retroactive application in civil cases." 111 S.Ct. at 2445. Therefore, the Department urges that, if the Iowa law is held to be unconstitutional, this Court expressly state that the Court is not ruling on the question of retroactivity but is expressly reserving the question for the Iowa courts to decide on remand.

The retroactivity question in this case is made more complicated by the fact that the Department, as a condition to receiving payment of taxes, agreed that in the event any of the issues in this case are decided in favor of Kraft, then Kraft and its former affiliate, Dart Industries, Inc. (Dart), would have full use, benefit and advantage of such decision with respect to calendar year 1975 and all years thereafter as to Kraft and with respect to calendar year 1971 and all years thereafter as to Dart. (Pet. App. 43a, Stip. ¶ 26; Exhs. A and B) The agreements were made prior to the decision in *Beam* which invalidated selective prospectivity. Therefore, the effect, if any, of *Beam* on whether the Department may deny refunds to corporate taxpayers will have to be determined. In addition, the Iowa Supreme Court should decide whether the agreement between the Department and Kraft is binding on that Court or whether that Court's inherent powers allow it to provide for prospectivity as to Kraft, Dart, and all other taxpayers. These determinations should be made in the first instance by the Iowa courts.

CONCLUSION

The Court should affirm the ruling of the Iowa Supreme Court. If the Court does not so affirm, it should expressly reserve the retroactivity question for the Iowa Supreme Court to decide on remand.

Respectfully submitted,

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APPENDIX

Relevant portions of 26 U.S.C. §§ 882(a), 991, and 995(a), as in effect in 1981, provided as follows:

§ 882. Tax on income of foreign corporations connected with United States business

(a) Imposition of tax

(1) In general

A foreign corporation engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 11 or 1201(a) on its taxable income which is effectively connected with the conduct of a trade or business within the United States.

(2) Determination of taxable income

In determining taxable income for purposes of paragraph (1), gross income includes only gross income which is effectively connected with the conduct of a trade or business within the United States.

§ 991. Taxation of a domestic international sales corporation

For purposes of the taxes imposed by this subtitle upon a DISC (as defined in section 992(a)), a DISC shall not be subject to the taxes imposed by this subtitle except for the tax imposed by chapter 5.

§ 995. Taxation of DISC income to shareholders

(a) General rule

A shareholder of a DISC or former DISC shall be subject to taxation on the earnings and profits of a DISC as provided in this chapter, but subject to the modifications of this subpart.

26 U.S.C. § 921(a) (1988) provides:

§ 921. Exempt foreign trade income excluded from gross income

(a) Exclusion. – Exempt foreign trade income of a FSC shall be treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States.

26 U.S.C. § 245(c)(1) (1988) provides:

§ 245. Dividends received from certain foreign corporations

. . . .

(c) Certain dividends received from FSC. –

(1) In general. – In the case of a domestic corporation, there shall be allowed as a deduction an amount equal to –

(A) 100 percent of any dividend received by such corporation from another corporation which is distributed out of earnings and profits attributable to foreign trade income for a period during which such other corporation was a FSC, and

(B) 70 percent (80 percent in the case of dividends from a 20-percent owned corporation as defined in section 243(c)(2)) of any dividend received by such corporation from another corporation which is distributed out of earnings and profits attributable to qualified interest and carrying charges received or accrued by such other corporation while such other corporation was a FSC.

Iowa Code § 422.32(4) (1958)

Division III. Business Tax On Corporations

422.32 Definitions. For the purpose of this division and unless otherwise required by the context:

. . . .

4. The term "Internal Revenue Code of 1954" means Internal Revenue Code of 1954, as amended to and including December 31, 1956.

Iowa Code § 422.3(5) (1989)

422.3 Definitions controlling chapter.

For the purpose of this chapter and unless otherwise required by the context:

. . . .

5. "Internal Revenue Code" means the Internal Revenue Code of 1954, prior to the date of its redesignation as the Internal Revenue Code of 1986 by the Tax Reform Act of 1986, or means the Internal Revenue Code of 1986 as amended to and including January 1, 1988, whichever is applicable.

Iowa Code § 422.32(6) and § 422.32(7) (1991)

6. "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

7. "Nonbusiness income" means all income other than business income.

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No. 90-1918

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

KRAFT GENERAL FOODS, INC.
(formerly KRAFT, INC.),

Petitioner,

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE,

Respondent.

On Writ of Certiorari to the Supreme Court of Iowa

REPLY BRIEF FOR PETITIONER

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PARTIES TO THE PROCEEDING

The statement provided pursuant to Rule 29.1 in Petitioner's Brief at page ii is currently accurate and requires no amendment.

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KRAFT GENERAL FOODS, INC.
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IOWA DEPARTMENT OF REVENUE AND FINANCE,
Respondent.

On Writ of Certiorari to the Supreme Court of Iowa

REPLY BRIEF FOR PETITIONER

SUMMARY OF ARGUMENT

Contrary to the assertions of respondent and the United States, the Iowa taxing scheme involves discrimination against foreign commerce and does not differentiate based merely on place of incorporation. First, the use of foreign corporations to conduct foreign operations is a part of foreign commerce. Moreover, the Iowa taxing scheme differentiates in the tax treatment of dividends based at least in part on the location of the activities conducted by the dividend-paying subsidiary.

Amerada Hess Corp. v. *Director*, 490 U.S. 66 (1989), is not to the contrary. That case merely held that there can be no discrimination against commerce if the difference in treatment is based *solely* on the *nature* of the activities involved, and not at all on where they are conducted.

The possibility of using a domestic corporation to conduct foreign operations or a domestic holding company to hold the stock of petitioner's foreign subsidiaries, as suggested by respondent and the United States, cannot validate the Iowa statute. As stipulated by the parties, the use of domestic corporations to conduct foreign operations may not be permitted by particular foreign countries. If domestic corporations could be used, signficant conversion costs would be incurred. Moreover, any taxing scheme that requires such a change in structure to avoid a discriminatory tax "forecloses tax-neutral decisions" in violation of the Commerce Clause.

Respondent cannot escape accountability for its discriminatory taxing scheme merely because it is based on the federal Internal Revenue Code. The Iowa taxing statute must independently satisfy the requirements of the Constitution.

The attempt by respondent and the United States to focus on the tax burden borne by a subsidiary's "unitary income stream" is inappropriate. This Court has never tested the validity of a state taxing statute by examining the application of other taxing schemes to other entities. If such an examination were appropriate, its focus must be at the state level, where a proper comparison of tax burdens can be made. On that basis, the foreign subsidiary's income stream

bears a greater tax burden than that of a domestic subsidiary.

The Iowa statute violates the Equal Protection Clause. Respondent continues to offer no legitimate or rational explanation for why it discriminates in the taxation of subsidiary dividends. All respondent has offered to justify its discrimination is the convenience it finds in adopting the federal scheme. It presents no justification at all for the discrimination itself.

If this Court should decide the case in favor of petitioner on basic constitutional principles, the decision should be applied retroactively.

ARGUMENT

I. THE IOWA TAXING SCHEME FACIALLY DISCRIMINATES AGAINST FOREIGN COMMERCE

Both respondent and the United States argue strenuously that this case does not involve discrimination against foreign commerce. Instead, for the first time, they claim that this case involves only a difference in tax treatment based on the subsidiary's place of incorporation. This claim is unfounded.

The Iowa taxing scheme facially discriminates against foreign commerce by singling out for inclusion in a parent's tax base dividends paid by foreign subsidiaries conducting business operations in foreign countries. There is no dispute that foreign commerce comprehends foreign business operations. There should also be no dispute, for reasons made clear by the record in the instant case, that the use of a foreign corporation to conduct such operations is a part of foreign commerce.

A. The Use of a Foreign Corporation to Conduct Foreign Operations Is a Part of Foreign Commerce

Both respondent and the United States have forgotten, or have conveniently chosen to disregard, the stipulation of the parties regarding the conduct of foreign operations. As petitioner and respondent expressly agreed (Pet. App. 30a-31a, Stip. 10), domestic corporations typically do business in foreign countries through foreign subsidiaries for a variety of reasons. Those reasons include "the requirements of the local country, a better ability to limit their liability in that country, the marketing advantage of being perceived by customers as a local company, greater ease in repatriating funds, greater ease in borrowing funds locally, and ability to own property and manufacture in that country." (*Ibid*)

Notwithstanding the express recognition by stipulation that fundamental commercial considerations can, and do, dictate the use of foreign corporations to conduct foreign operations, respondent makes the flat assertion that "Kraft could do business in foreign countries through domestically incorporated subsidiaries." (Res. Br. 10) Although nothing is cited in support of this assertion, both respondent and the United States make it a major element of their case.

As the stipulation unequivocally establishes, the use of a foreign corporation can be integral to the conduct of foreign operations. Local requirements, as well as local business considerations, cause that to be true. Any attempt to isolate the foreign corporation itself from the foreign activities that it conducts is totally unwarranted. The foreign entity that engages in foreign activities is as much a part of foreign commerce as are the activities themselves.

Despite the insistence of respondent and the United States, the "structure" argument cannot remove the Commerce Clause issue from the instant case.

B. The Iowa Taxing Scheme Also Discriminates Against Foreign Operations

Taking the Iowa scheme as a whole, as the United States acknowledges must be done (*see* U.S. Br. 10, *citing*, *Halliburton Oil Well Cementing Co.* v. *Reily*, 373 U.S. 64, 69 (1963)), it is apparent that Iowa does not base its taxation of dividend income *solely* on the place of incorporation. Rather, by adopting the federal tax code, Iowa has accepted a pattern of dividend taxation that is geared to *both* the place of incorporation *and* the location of activities.

The United States acknowledges this fact when it argues:

> The Iowa tax, by incorporating the federal distinctions, differentiates in its treatment of dividend income based upon the place of incorporation of the subsidiaries *and whether those subsidiaries are themselves subject to domestic taxation* (see notes 6 & 8, *supra*), not simply upon "the location of their activities" (*Amerada Hess Corp.* v. *Director*, 490 U.S. at 78).

(U.S. Br. 11) (Emphasis supplied.)

The United States thus correctly observes that the Iowa tax differentiates based upon *both* the place of incorporation of the dividend-paying subsidiaries *and* "whether those subsidiaries are themselves subject to domestic taxation." As previously pointed out (U.S. Br. 10-11; Pet. Br. 4-7), the categories of dividend-paying subsidiaries that are "themselves subject to

domestic taxation" are domestic subsidiaries (with either domestic or foreign operations), and foreign subsidiaries to the extent they conduct domestic operations. The only group of subsidiaries that is *not* "subject to domestic taxation" is that consisting of *foreign* subsidiaries engaged in *foreign* operations. Corporations satisfying both of those elements are in the disfavored group. Accordingly, even if the discrimination in the Iowa taxing scheme is not based entirely on the location of activities, it is clearly based in large part on that factor.

Both respondent and the United States cite *Amerada Hess Corp.* v. *Director*, 490 U.S. 66 (1989), for the proposition that a tax can be held to discriminate against commerce only if it differentiates based on the location of activities. However, nothing in *Amerada Hess* suggests that impermissible discrimination under the Commerce Clause can be found only when the difference in treatment at issue is based *solely* on the location of activities. *Amerada Hess* made the converse distinction. In that case, this Court declared that there could be no discrimination under the Commerce Clause where the difference in treatment there involved, between oil producers and non-producing retailers, was based *solely* on the difference in the nature of their two businesses, and not at all on the location of their activities.[1]

[1] *Amerada Hess* upheld a provision requiring the "add back" of all federal taxes on income and profits, including the windfall profits tax, in the computation of the New Jersey corporate tax base. The fact that only oil producers were subject to the windfall profits tax did not mean that requiring them to add back the tax caused an impermissible discrimination in favor of non-producing retailers, who were not subject to the tax and therefore could not add it back. The difference in treatment under New Jersey law was based solely on the difference in the two types of businesses, not on where they were conducted.

Amerada Hess does not hold that discrimination based only in part on location of activities fails to implicate the Commerce Clause.

II. THE POSSIBILITY OF USING A DOMESTIC CORPORATION OR DOMESTIC HOLDING COMPANY CANNOT VALIDATE THE IOWA STATUTE

Both respondent and the United States declare that petitioner could eliminate Iowa's discrimination by using domestic subsidiaries to conduct its various foreign operations or by forming a domestic holding company to hold the stock of its foreign subsidiaries. Neither of these alternatives, put forward for the first time in this Court, can validate the Iowa statute.

A. Use of Domestic Corporations to Conduct Foreign Operations

Once again, both respondent and the United States have either overlooked or chosen to ignore the stipulation of the parties. As there stated, foreign governments may not even permit domestic corporations to conduct business in their countries. (Pet. App. 30a-31a, Stip. 10) Thus, the blanket suggestion that petitioner could use domestic subsidiaries to conduct its wide range of foreign activities cannot be valid.

Even where it might be possible to use a domestic corporation for particular foreign operations, both respondent and the United States have completely ignored the numerous costs that would accompany any such conversion. For example, under section 367 of the Internal Revenue Code and the regulations thereunder, petitioner could well be taxed at the fed-

eral (and presumably state) level on the mere transfer of its foreign assets to a domestic subsidiary.

In any event, requiring a corporation engaged in foreign commerce to incorporate in the United States in order to avoid discriminatory taxation "forecloses tax-neutral decisions" regarding the structure and operation of its foreign activities. A taxing scheme that produces such a result impermissibly discriminates against foreign commerce. Surely, the Foreign Commerce Clause precludes state taxing schemes that induce domestic relocations of an operational or structural nature by discriminatorily taxing foreign operations conducted by foreign corporations. *Compare Westinghouse Electric Corp.* v. *Tully*, 466 U.S. 388, 406 (1984); *Boston Stock Exchange* v. *State Tax Comm'n*, 429 U.S. 318, 333 (1977); *Halliburton Oil Well Cementing Co.* v. *Reily*, 373 U.S. 64, 72 (1963).

B. Use of a Domestic Holding Company

Apparently recognizing the weakness in their initial suggestion, both respondent and the United States suggest in the alternative that petitioner establish a domestic subsidiary holding company to escape Iowa's discriminatory tax. Presumably, the holding company would hold the stock of the foreign subsidiaries, receive dividends from them, and pass those dividends on to petitioner as domestic subsidiary dividends.

This suggestion assumes that the holding company would be located in a state that would not discriminate in taxing the foreign subsidiary dividends when first received. If, however, all states applied a taxing scheme similar to that of Iowa (as the United States recognizes is the appropriate way to test the issues here presented (U.S. Br. 18); *see also Halliburton*,

373 U.S. at 69), petitioner's foreign subsidiary dividends would be taxed when received by the holding company and nothing would be accomplished.[2]

Moreover, as noted above, any taxing scheme that requires (or even encourages) the formation of a domestic entity to avoid discriminatory taxation against foreign commerce "forecloses tax-neutral decisions" regarding the structure and conduct of multinational operations. This the Commerce Clause simply does not tolerate. *Compare Westinghouse Electric Corp.* v. *Tully*, 466 U.S. at 406; *Boston Stock Exchange* v. *State Tax Comm'n*, 429 U.S. at 333.

Accordingly, the suggestion to form a domestic holding company to hold petitioner's foreign subsidiary stock and receive its foreign subsidiary dividends cannot resolve the discrimination issue here presented.

III. IOWA CANNOT DEFEND ITS DISCRIMINATION BY ASSERTING THAT ITS TAXING SCHEME IS BASED ON THE FEDERAL SYSTEM

Iowa attempts to escape accountability for its discriminatory taxing scheme by asserting that since it has adopted the federal taxing statute for convenience, it need not test the validity of each provision under the Constitution.

> Also, if states have to scrutinize all IRC provisions and future amendments to determine whether they favor one type of commerce

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[2] Respondent recommends the use of a "non-Iowa" holding company. (The United States makes no such recommendation.) But, if every state had Iowa's taxing scheme, respondent's recommendation would still be futile.

> over another, it will no longer be convenient for states to couple with the IRC.

(Res. Br. 18)

Not only does the foregoing statement reflect a complete disregard for constitutional obligations, but it is also somewhat disingenuous. Iowa has had no hesitancy in selectively modifying the federal tax law to suit its own policies. For example, in 1981, Iowa's taxing statute required corporate taxpayers to make nine separate adjustments to their federal taxable income in order to determine their proper Iowa tax base. It now requires 14 such adjustments. In addition, Iowa law, unlike federal law, did not, and still does not, tax the "gross up" amount on foreign dividends or allow a credit for foreign taxes paid.[3]

Judging by its conduct and its comments, respondent appears simply not to relish the burden of ensuring that its tax law is constitutional.[4] Iowa's discrimination cannot be excused merely because the Iowa taxing statute is based in part on the federal tax code. The standard for determining the constitutionality of a state taxing scheme is not inevitably the same standard as that imposed at the federal level.

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[3] Petitioner does not intend to suggest that Iowa must grant a credit for foreign taxes paid. Under *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159 at 191 n.30 (1983), such a credit may not be constitutionally required. And, in any event, it would not totally eliminate the discrimination.

[4] Interestingly, twenty-six states adopting the federal taxing scheme have found a way to eliminate the discrimination here involved. (Pet. 6-7)

IV. RESPONDENT CANNOT SAVE THE IOWA STATUTE BY ANALYZING THE TAX BURDEN ON THE "UNITARY INCOME STREAM"

Respondent also focuses on the taxation of what it calls the "unitary income stream." (Res. Br. 21) It asserts that Iowa's taxing scheme does not discriminate against foreign commerce because "[i]f every state adopted the Iowa method of taxation, the unitary earnings of domestic subsidiaries would be subject to state and United States taxation which could be more burdensome than the taxation of the foreign subsidiary earnings." (*Ibid*)[5]

In evaluating a claim of facial discrimination, this Court has refused to take into account whether any taxes were imposed by other jurisdictions on the entity claiming discrimination (such as petitioner in the instant case.) *Armco Inc.* v. *Hardesty*, 467 U.S. 638, 644-645 (1984). *See also Tyler Pipe Indus., Inc.* v. *Washington State Dep't of Revenue*, 483 U.S. 238, 242 (1987); *Freeman* v. *Hewitt*, 329 U.S. 249, 256 (1946). *A fortiori*, this Court should not take into account any taxes imposed on *other* entities (*i.e.*, petitioner's subsidiaries) in testing petitioner's claim. In addition, in undertaking such a test this Court certainly should not take into account any taxes on petitioner or any other entities imposed by other levels of government (*e.g.*, the federal government). For these reasons, the tax burden on the so-called "unitary income stream" is irrelevant and should be disregarded.

Moreover, if this Court were to undertake such an inquiry, respondent's position has no merit for two

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[5] The United States makes a similar argument. (Br. U.S. 13 n.18, 21-23)

reasons. First, at the state level, dividends and earnings fall into two distinct pools of income; they are not a unified income stream. The taxation of one of those distinct pools is not related to the taxation of the other. Second, assuming arguendo that the entire income stream should be examined as respondent suggests, a domestic subsidiary income stream would actually bear *less* of a tax burden at the state level than the foreign income stream here involved.

A. At the State Level, Dividends and Earnings are Distinct Pools of Income, Not a Unified Income Stream

For purposes of state taxation, in the absence of reporting requirements that combine parent and subsidiary incomes (*see, e.g., Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159 (1983)), a subsidiary's earnings and the dividends received by its parent constitute two distinct pools of income earned by two different entities. They are not one continuous income stream. Cf. *id.* at 191 n.30.

Iowa's apportionment of corporate income illustrates the distinct nature of earnings and dividends.[6] Iowa apportions a subsidiary's earnings based on the level of the *subsidiary's* activity in that state (subsidiary's sales in Iowa over subsidiary's total gross sales). In contrast, Iowa apportions a parent company's income, including the dividends it receives from its subsidiaries, based on the level of the *parent's* activity in that state (parent's sales in Iowa over parent's total gross sales). Thus, Iowa would tax only

[6] Iowa neither requires nor permits worldwide combined reporting. Consequently, under Iowa law, the earnings of a parent would never be combined with the earnings of its foreign subsidiaries.

10% of the earnings of a subsidiary that has 10% of its sales in Iowa. If such a subsidiary were to pay a dividend equal to 100% of its earnings to its parent doing business in Iowa, the extent to which the dividend would be subject to tax in Iowa, if at all, would be determined by reference to the extent of the *parent's* business conducted there, not the subsidiary's business conducted there. There would be no correlation, except by coincidence, between the extent to which the subsidiary's earnings were taxed by Iowa and the extent to which the dividends would be taxed at the parent level.[7]

Thus, again, any taxes imposed on underlying earnings should have no bearing on the constitutionality of the Iowa tax imposed on dividends.

B. If Income Stream Analysis is Relevant, the Foreign Income Stream Bears a Heavier Overall Tax Burden at the State Level Than Does the Domestic Income Stream

If this Court were to determine that Iowa's taxation of a subsidiary's "unitary income stream" is relevant to the issue here presented, Iowa's taxing statute is nevertheless unconstitutional because the income stream of a foreign subsidiary operating abroad is subjected to a heavier state tax burden than that of a domestic subsidiary doing business at home. As the United States recognizes, the state tax burden on a subsidiary's income stream must be measured by assuming that all states have adopted Iowa's challenged taxing statute. ("To determine whether Iowa's tax is *facially* discriminatory, however, it is relevant to ob-

[7] In the federal context, the notion of an "income stream" might be more appropriate because of the absence of separate apportionment at the parent and subsidiary levels.

serve how foreign and domestic commerce would fare if the Iowa scheme were applied by all States." (U.S. Br. 13 n.18) (Emphasis in original) *See also Armco Inc.* v. *Hardesty*, 467 U.S. at 644-645; *Tyler Pipe*, 483 U.S. at 247-248; *Halliburton*, 373 U.S. at 72.

What the United States fails to comprehend, however, is that it is also relevant (and thus necessary) in the foreign context to assume that all other comparable taxing jurisdictions (here, those in the foreign countries where petitioner's subsidiaries operate) would also apply Iowa's scheme. Otherwise the comparison would be meaningless.

Under a proper analysis, it is clear that the underlying earnings of *both* the domestic subsidiaries and the foreign subsidiaries would be fully taxed. Yet, Iowa would exclude only domestic subsidiary dividends from the parent's tax base. Thus, if adopted everywhere, Iowa's taxing scheme would systematically expose the foreign subsidiary's income stream to an additional tax burden to which the domestic subsidiary's income stream would not be exposed. For that reason, the Iowa scheme impermissibly burdens foreign commerce.[8]

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[8] In fact, the record in the instant case shows that petitioner's income from foreign subsidiaries operating abroad actually was burdened with three levels of tax—a foreign tax on underlying subsidiary earnings, a foreign withholding tax on the dividends when paid, and an Iowa tax on the dividends when received. (Pet. App. 2a, 12a) In contrast, as respondent recognizes, domestic subsidiary income from domestic operations would, at most, only be taxed twice—once at the federal level and once at the state level. (Res. Br. 21)

V. THE IOWA STATUTE VIOLATES THE EQUAL PROTECTION CLAUSE

If this Court somehow agrees with respondent and the United States that the Iowa taxing scheme discriminates based *solely* on place of incorporation, and that place of incorporation does not constitute commerce on the record here presented, such discrimination nevertheless represents a clear violation of the Equal Protection Clause.

The basis for the difference in the federal tax treatment of subsidiary dividends is the fact that the federal government has chosen to allow dividend relief in those cases where it is able to tax underlying subsidiary earnings. That may be a perfectly permissible ground for differentiation in the tax treatment of dividends at the federal level.

At the state level, however, the focus must be different. Iowa justifies its adoption of the federal scheme on grounds of taxpayer and administrative convenience, which it claims is a legitimate and rational state purpose. But the question for Iowa is, having selectively adopted the federal scheme as its own, what justification can Iowa offer for differentiating in the treatment of subsidiary dividends based on place of incorporation?[9]

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[9] The United States recognizes the point but merely says:

> The different treatment of dividends received from foreign-incorporated subsidiaries, as compared to those from domestic-incorporated subsidiaries, serves legitimate, rational state purposes. *See* Pet. App. 9a-10a; pages 9-23, *supra*.

(U.S. Br. 23)

All Iowa has offered to justify its discrimination is *the convenience it finds in adopting the federal scheme.* But convenience in adopting statutory language is not a legitimate and rational reason for singling out for taxation dividends paid by foreign subsidiaries conducting foreign operations.

VI. RETROACTIVITY

Respondent argues that, in the event its taxing scheme is held to be unconstitutional, this Court should expressly reserve the question of retroactivity for the Iowa courts to consider on remand. Petitioner sees no basis for such a reservation with respect to the issue here presented.

Invoking the doctrine of prospective application declared in *Chevron Oil* v. *Huson*, 404 U.S. 97 (1971), would not be appropriate here. A decision of this Court striking down the Iowa tax on foreign subsidiary dividends would involve no overruling of precedent and would break no new ground. While the issue is one of first impression, its resolution would have been clearly foreshadowed by such existing precedent as *Cook* v. *Commonwealth of Pennsylvania*, 97 U.S. 566 (1878), and *Hale* v. *Bimco Trading, Inc.*, 306 U.S. 375 (1939), both of which struck down statutes that facially discriminated against foreign commerce.

A decision for petitioner would surely represent an application of settled principles to the circumstances here presented. As a result, there would be no need for this Court to reserve on the question of retroactive application in the instant case.

Respondent attempts to cloud the issue by referring to its agreement with petitioner under which respondent committed to apply the decision retroactively as to petitioner if this Court invalidated the statute. Respondent now claims that this Court's decision in *James B. Beam Distilling Co.* v. *Georgia*, 111 S.Ct. 2439 (1991), which rejected the doctrine of selective prospectivity on the facts there presented, somehow may throw the validity of its agreement into question.

Respondent ignores the fact that the agreement deals with remedies, not choice of law. The agreement simply commits respondent to the adoption of a particular remedy should petitioner prevail in the instant case. The agreement in no way relates to the choice of law issue raised by respondent. Nothing in *Beam* even bears on the question of remedies. *Beam* reiterates the rule that remedies are entirely a matter of state law.

Respondent's sudden suggestion of unwillingness to adhere to its agreement because of *Beam* is unconscionable. But it affords no basis for this Court to deny or delay the retroactive application of a decision that may be favorable to petitioner on basic constitutional principles.

CONCLUSION

For all of the foregoing reasons, the decision of the Supreme Court of Iowa should be reversed.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1991

KRAFT GENERAL FOODS, INC.
(Formerly KRAFT, INC.), PETITIONER

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE

ON WRIT OF CERTIORARI TO THE SUPREME COURT OF IOWA

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING RESPONDENT

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QUESTION PRESENTED

Whether Iowa discriminates against foreign commerce in violation of the Commerce Clause or the Equal Protection Clause of the Constitution of the United States by imposing its annual tax on the apportioned "net income" of corporations doing business in the State and by defining "net income" for this purpose to mean "the taxable income * * * as properly computed for federal income tax purposes under the Internal Revenue Code" (Iowa Code Ann. § 422.35 (West 1990)).

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INTEREST OF THE UNITED STATES

The Constitution vests legislative power in the Congress to "lay and collect taxes on incomes" (U.S. Const. Amend. XVI) and to "regulate Commerce with foreign Nations" (U.S. Const. Art. I, § 8, Cl. 3). It is contended in this case that Iowa has violated the Commerce Clause and the Equal Protection Clause by enacting a tax scheme that incorporates some, but not all, of the provisions of the Internal Revenue Code affecting the treatment of dividend income received by a corporation from foreign-incorporated subsidiaries. The effects of the federal statutory scheme are thus central to evaluation of the claims in this case. At the Court's invitation, the United States filed a brief *amicus curiae* at the petition stage of this case.

STATEMENT

1. Petitioner is a Delaware corporation with its principal place of business in Illinois.[1] During 1981, petitioner conducted a unitary business within the United States and, through foreign subsidiaries, in certain foreign countries.[2] Part of this unitary business was conducted by petitioner in the State of Iowa. Pet. App. 28a-29a, 33a.

On June 3, 1985, the Director of Revenue of the State of Iowa issued a notice of assessment to petitioner for taxes, interest, and fees due for 1981 in the aggregate amount of $51,756.62 (Pet. App. 32a-33a). The assessment was made under Section 422.33 of the Iowa Code Ann. (West 1990), which imposes an annual tax on the apportioned "net income" of corporations doing business in the State (Pet. App. 3a, 58a). Section 422.35 of the Iowa Code Ann. (West 1990) (Pet. App. 62a), with adjustments not at issue here, defines the term "net income" as "taxable income * * * as properly computed for federal income tax purposes under the Internal Revenue Code of 1954." The Iowa Code thus incorporates federal "taxable income" as the base upon which the State's annual tax upon corporate "net income" is computed.

With respect to corporations, Section 63(a) of the Internal Revenue Code[3] defines "taxable income" as

[1] Petitioner is the successor by merger of another Delaware corporation, Kraft, Inc., that during calendar year 1981 had its principal office and commercial domicile in Illinois and was qualified to do business, and did business, in Iowa. References in this brief to "petitioner" are either to the corporation active at the time referred to, or to both corporations.

[2] The record does not identify the States (other than Iowa and Illinois) or the foreign countries in which petitioner conducted its unitary business.

[3] References to the Internal Revenue Code are, unless otherwise indicated, to the Internal Revenue Code of 1954 (26 U.S.C.) as amended and effective during 1981.

"gross income minus the deductions allowed by this chapter." 26 U.S.C. 63(a). The term "gross income" includes "dividends" (26 U.S.C. 61(a)(7)),[4] but, in 1981, Section 243 of the Code allowed a corporation to deduct 85%[5] of the dividends it received from another *domestic* corporation that was itself subject to the federal income tax and 100% of the dividends it received from such a *domestic* corporation that it controlled by ownership of at least 80% of its stock.[6] 26 U.S.C. 243 (1979).[7] Dividends received from a *foreign* corporation that was not subject to the federal income tax,[8] however, were not deductible in determining the "taxable income" of a corporation under the Internal Revenue Code. The Code, however, provides an election to the corporate taxpayer

[4] The term "dividends" is defined in 26 U.S.C. 316(a).

[5] Section 243 has been amended several times since 1981. The dividends-received deduction remains at 100% in the case of dividends from affiliated corporations or from certain small business investment companies, but is now generally 70% in the case of other eligible dividends. 26 U.S.C. 243.

[6] The deductions are available only if the domestic corporations that paid the dividends are themselves subject to the federal income tax. 26 U.S.C. 243.

[7] The term "domestic corporation" is defined in Section 7701(a)(4) of the Code as a corporation organized under the law of the United States or of any State. 26 U.S.C. 7701(a)(4). Throughout this brief, the term "domestic corporation" will be used with this meaning, and the term "foreign corporation" will refer to a corporation incorporated outside the United States.

[8] Dividends paid by a foreign corporation may be deductible in part, to the extent that they, like domestic corporations, are subject to United States taxation. Section 882 of the Internal Revenue Code imposes the federal income tax upon foreign corporations to the extent that such corporations receive "taxable income which is effectively connected with the conduct of a trade or business within the United States." 26 U.S.C. 882(a)(1). Under Section 245(a)(3) of the Code, as it has been amended from time to time, the dividends paid by a foreign corporation that is subject to the federal income tax may, in specified circumstances, be deducted in determining the

either to deduct the foreign income taxes it has paid on earnings from its own foreign operations and on dividends received from a foreign corporation (26 U.S.C. 164(a)(3)) or, instead, to take a credit against its federal income taxes based on (i) the amount of the foreign income taxes it paid (26 U.S.C. 901) and (ii) the amount of foreign income taxes paid by a foreign-incorporated subsidiary with respect to the fraction of the earnings distributed as dividends to the taxpayer (26 U.S.C. 902).[9] If the taxpayer elects to take the tax credits allowed by Sections 901 and 902, it may not take the deduction for foreign income taxes allowed by Section 164. See 26 U.S.C. 275(a)(4).

As a result, when a corporate taxpayer received dividends in 1981, whether from domestic or from foreign corporations, the Internal Revenue Code required that the amount of those dividends be included in gross income, but then, in computing "taxable income," allowed

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taxable income of the recipient corporation. The current form of Section 245 provides that a domestic corporation that owns at least 10% of the stock of a foreign corporation may deduct the portion of the dividends that it receives from that corporation that reflects the earnings of the foreign corporation from "the conduct of a trade or business within the United States and subject to [the federal income] tax." 26 U.S.C. 245(a)(5)(A). Additionally, the dividends received by a domestic parent from a wholly-owned foreign subsidiary are fully deductible if all of the income of the foreign subsidiary "is effectively connected (or treated as effectively connected) with the conduct of a trade or business within the United States." 26 U.S.C. 245(b)(1). During 1981, Section 245(a) was somewhat more restrictive, requiring, for example, the foreign corporation to have engaged in a significant portion of its business in the United States for a period of at least 36 months for its dividends to qualify for the deduction. 26 U.S.C. 245(a) (1979).

[9] This portion of the foreign income taxes paid by the foreign subsidiary is "deemed to have [been] paid" (26 U.S.C. 902(a)) by the domestic parent corporation for the purpose of computing its federal income tax credit. The Court has recently considered some of the questions arising with respect to the credit provided by Section 902 in *United States* v. *Goodyear Tire & Rubber Co.*, 493 U.S. 132 (1989).

a deduction of 85% or 100%, as the case might be, of the amount of dividends received from taxable domestic corporations. In basing its corporate income tax upon an apportioned fraction of "net income," defined as "the taxable income * * * as properly computed for federal income tax purposes," Iowa to that extent accepts and follows the federal pattern. Iowa also follows the federal pattern in which deductions (including the deduction for foreign income taxes paid by the taxpayer) reduce "taxable income," but in which income tax credits elected by the taxpayer (under Sections 901 and 902) in lieu of deductions (under Section 164) do not.

During 1981, petitioner owned more than 80% of the stock of several corporations organized and conducting their respective segments of petitioner's unitary business outside the Untied States. Six of those foreign subsidiaries paid dividends in that year in the aggregate amount of $10,181,815, of which, after foreign income taxes in the amount of $1,490,887 were withheld,[10] petitioner received $8,690,928 (Pet. App. 52a-53a).[11] On its federal income tax return for 1981, petitioner included the foreign subsidiary dividends as part of its gross income and elected to claim a credit against its federal

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[10] Sections 1441 and 1442 of the Internal Revenue Code similarly impose a tax withholding obligation for dividends and certain other regular payments to nonresident aliens and foreign corporations. The federal withholding is at the rate of 30% except as reduced by treaty provisions. See 26 U.S.C. 1441(a), 1442(a).

[11] The stipulated facts do not disclose what fraction of petitioner's net income was apportioned to, and taxed by Iowa, and what fractions were apportioned to what other States. Similarly, those facts do not disclose whether petitioner itself engaged in business beyond, as well as within, the United States, and might have had other deductible, or creditable, foreign income taxes. In conformity with Rule 29.1 of the Rules of this Court, petitioner lists 86 subsidiaries other than wholly owned subsidiaries (Br. App. 1a-3a). The names suggest that most, if not all, are foreign corporations. The list does not include the six subsidiaries (identified at Pet. App. 52a-53a and Br. 3) whose dividends are at issue in this case.

income tax, rather than a deduction, with respect to the foreign taxes it paid (*id.* at 32a).[12]

In computing "net income" on its Iowa corporate income tax return for 1981, petitioner did not adhere to the definition of "taxable income" in the Internal Revenue Code. Instead, petitioner deducted from its reported federal "taxable income" the dividends that it had received from its foreign subsidiaries (Pet. App. 32a). The deficiency assessed by the Director of Revenue of the State of Iowa required those foreign dividends to be included in petitioner's "net income" because the dividends from those foreign corporations did not give rise to a deduction in computing "taxable income" under the Internal Revenue Code (*id.* at 32a-33a).

Petitioner protested the asserted deficiency to the Iowa State Department of Revenue and Finance, asserting that inclusion of the dividends it received from foreign subsidiaries in its net income discriminated against foreign commerce, in violation of the Commerce Clause of the Constitution of the United States, and denied it the equal protection of the laws in violation of the Fourteenth Amendment. The Director of Revenue and Finance denied the protest, noting that he had no authority to question or decide the constitutionality of the State's laws (Pet. App. 24a-27a).

2. The District Court of Polk County, acting on the basis of a stipulated record (Pet. App. 28a-56a), upheld the assessment (*id.* at 11a-23a). The court held that "Kraft has not shown that the Iowa tax in any way benefited local in-state industry in detriment to out-of-state industry" (*id.* at 16a) and "has not shown that the Iowa tax exerts a pressure on interstate business to conduct more of it activities in Iowa" (*id.* at 17a). The court characterized as "wholly speculative" the argument that if other States followed the Iowa pattern, "it would

[12] If petitioner had not elected the tax credit, its "taxable income" (for both federal and Iowa purposes) would have been reduced by the amount of foreign taxes that petitioner paid.

be a 'powerful persuader' to locate foreign operations within U.S. boundaries" (*ibid.*). The court therefore rejected (*id.* at 22a-23a) petitioner's Commerce Clause and equal protection claims.

3. The Supreme Court of Iowa affirmed (Pet. App. 1a-10a). In response to petitioner's charge that the Iowa corporate income tax discriminated against foreign commerce, the court stated that "the question is whether Iowa businesses are benefited at the expense of foreign businesses" (*id.* at 7a) and concluded that "[b]ecause the Iowa tax does not differentiate between in-state or out-of-state taxpayers no impermissible discrimination exists" (*id.* at 7a-8a). The court also rejected petitioner's equal protection claim, noting (*id.* at 9a) that no suspect classification or fundamental right was at issue and that use of the federal concept of "taxable income" served legitimate state purposes (as well as the convenience of taxpayers) in promoting economy of effort, convenience, and administrative efficiency (*id.* at 9a-10a).

SUMMARY OF ARGUMENT

I

Petitioner's contention that the different treatment under Iowa law of dividend income paid by foreign and domestic corporations "facially discriminates against foreign commerce" (Pet. Br. 11) is not correct. Under the Internal Revenue Code, as incorporated in the Iowa statute, the deductibility of dividends, whether paid by domestic *or* foreign corporations, generally depends upon whether, and to what extent, the earnings that were the source of the dividends were subject to tax in the United States. While there are differences in the treatment afforded to dividend income based upon the place of incorporation of the distributing corporation, those differences do not effect a discrimination based upon the location or nature of the commerce conducted. Domestic corporations may, and do, engage in foreign commerce; foreign corporations may, and do, engage in domestic

commerce. The distinctions made in the taxation of dividends paid by domestic and foreign corporations under the Internal Revenue Code and under Iowa law do not equate to distinctions based upon whether foreign or domestic commerce is involved.

Even if one accepts, however, the conceptual simplification that foreign corporations engage only in foreign commerce and domestic corporations engage only in domestic commerce, it is domestic commerce, rather than foreign commerce, that is "facially" subject to the greater burden under the Iowa scheme. The entire earnings of domestic subsidiaries (whether from domestic or foreign commerce) are subject to tax at the state level under the Iowa scheme; by contrast, only that part of the foreign earnings of a foreign subsidiary that is distributed to its domestic parent as a dividend is subject to tax at the state level under the Iowa scheme. The unitary business enterprise may thus achieve a benefit, rather than suffer a detriment, from conducting its foreign commerce by means of a foreign-incorporated subsidiary. Moreover, the Iowa scheme would allow the parent corporation, through use of a domestic subsidiary holding company, to elect tax treatment for foreign subsidiary income that is identical to the treatment of such income for a domestic subsidiary.

II

Since the Iowa tax does not discriminate against foreign-incorporated subsidiaries (much less against foreign commerce), there is no violation of either the Commerce Clause or the Equal Protection Clause. The different treatment of dividends received by a unitary business enterprise from foreign-incorporated, as compared to those from domestic-incorporated, subsidiaries serves legitimate, rational state purposes.

ARGUMENT

I. THE IOWA TAX DOES NOT VIOLATE THE FOREIGN COMMERCE CLAUSE

A state tax may unconstitutionally discriminate against foreign commerce if it "is facially discriminatory, has a discriminatory intent, or has the effect of unduly burdening [such] commerce" (*Amerada Hess Corp.* v. *Director*, 490 U.S. 66, 75 (1989)). Petitioner has offered no evidence in this case to suggest that the Iowa tax has a discriminatory intent or that it creates undue burdens on foreign commerce. Petitioner instead relies upon the assertion that the "Iowa tax scheme facially discriminates against foreign commerce" (Pet. Br. 11). The claim of facial discrimination against foreign commerce is not correct. The judgment of the Iowa Supreme Court should therefore be affirmed.[13]

A. The Iowa Tax Does Not Discriminate Against Foreign Commerce

Petitioner contends (Pet. Br. 11, 14-16) that the Iowa tax "facially discriminates against foreign commerce" because the dividends that a domestic parent corporation receives from a wholly-owned *foreign* subsidiary are included in its apportioned "net income" under state law while the dividends the parent receives from a wholly-owned *domestic* subsidiary are not. Petitioner's claim that this different treatment of foreign and domestic subsidiary dividend income under Iowa law represents a facial discrimination against "foreign commerce" errs

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[13] Petitioner contends that the facial discrimination against foreign commerce effected by the Iowa tax violates both the Commerce Clause and the Equal Protection Clause (Pet. Br. 14-17, 24-30). Because the Iowa scheme does *not* discriminate against foreign commerce, neither the Commerce Clause nor the Equal Protection Clause is properly invoked in this case. See page 23, *infra*.

in two respects: (i) it unduly equates the nature of the commerce conducted by a corporation with the location of its incorporation; and (ii) it erroneously views Iowa's treatment of dividends in isolation from all other features of the Iowa and federal tax schemes. As this Court stated in *Halliburton Oil Well Cementing Co.* v. *Reilly*, 373 U.S. 64 (1963), the constitutionality of a particular state tax provision must not be "[c]onsidered in isolation" (*id.* at 69). "[A] proper analysis must take the 'whole scheme of taxation into account.'" *Ibid.* (quoting *Galveston, H. & S.A. R.R.* v. *Texas*, 210 U.S. 217, 227 (1908)).

1. Under the Internal Revenue Code, as incorporated in the Iowa statute, the deductibility of dividends, whether paid by a domestic or foreign corporation, generally depends upon whether, and to what extent, the earnings that were the source of the dividends were subject to tax in the United States. Under Section 11 of the Internal Revenue Code, all of the earnings of domestic business corporations, whether derived from domestic or foreign commerce, are subject to the federal income tax (26 U.S.C. 11); Section 243 then allows a deduction for the receipt of dividends from such domestic corporations (26 U.S.C. 243). Under Section 882 of the Code, only the domestic earnings of foreign corporations are subject to the federal income tax (26 U.S.C. 882); Section 245, with certain limitations, therefore allows a deduction for the receipt of dividends paid from the domestic earnings of such foreign corporations (26 U.S.C. 245). The *foreign* earnings of foreign corporations are not, however, subject to the federal income tax (see 26 U.S.C. 882), and therefore no deduction is allowed for the receipt of a dividend paid from the foreign earnings of such foreign corporations (see 26 U.S.C. 245). See note 8, *supra*.

A differentiation in the treatment of dividend income that is based upon the subsidiary's place of incorporation

is thus not equivalent to a discrimination based upon the location or character of the commerce conducted by that corporation. A domestic subsidiary may, and often does, engage in foreign commerce; when it does, its foreign earnings are subject to the federal income tax. A foreign subsidiary may, and often does, engage in domestic commerce; when it does, its domestic earnings are subject to the federal income tax. In both of these situations, a deduction for dividends distributed from these earnings is available. But the *foreign* earnings of a foreign subsidiary are not subject to the federal income tax; as a corollary, a deduction is *not* available for dividends distributed from those untaxed earnings. The Iowa tax, by incorporating the federal distinctions, differentiates in its treatment of dividend income based upon the place of incorporation of the subsidiaries and whether those subsidiaries are themelves subject to domestic taxation (see notes 6 & 8, *supra*), not simply upon "the location of their activities" (*Amerada Hess Corp.* v. *Director*, 490 U.S. at 78).[14]

Just as Delaware corporations, such as petitioner, often earn significant portions of their income from commerce conducted outside of Delaware (and, indeed, outside of the United States), foreign corporations do not necessarily earn all of their income from commerce conducted abroad. It is therefore incorrect to equate distinctions based upon the location of incorporation with distinc-

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[14] For example, a domestic corporation and a foreign corporation might each earn 50% of their income from domestic commerce and 50% of their income from foreign commerce. Different treatment of the dividends paid by these corporations in assessing a tax against the domestic recipient would not be a discrimination based upon the type of commerce involved. Instead, as we discuss at pages 16-23, *infra*, the different tax treatment of the two dividends in this situation reflects rational efforts to allocate taxing authority among affected governments. See also note 8, *supra*.

tions based upon the location or type of commerce being conducted.[15] The situation is, in reality, far more complex.[16]

2. Even if one accepts, however, the conceptual simplification that foreign corporations engage only in foreign commerce and domestic corporations engage only in domestic commerce, the Iowa tax does not systematically or "facially" discriminate against foreign commerce.[17] In fact, domestic commerce is "facially" subject to the greater burden under the Iowa scheme.

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[15] The cases on which petitioner and its amici principally rely involve situations where the state tax applied differently based solely upon whether imported or domestic goods were involved. See, *e.g.*, *Cook* v. *Pennsylvania*, 97 U.S. 566 (1878) (differential tax on imported wares); *Hale* v. *Bimco Trading Co.*, 306 U.S. 375 (1939) (inspection fee on imported cement). Those decisions do not support a claim that differential treatment of foreign and domestic corporations is sufficient to establish that the State is engaged in discrimination against foreign commerce.

[16] See note 14, *supra*; B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶¶ 17.01-17.44 (5th ed. 1987). Petitioner attempts to avoid these complexities by theorizing that Iowa differentiates between its treatment of dividends paid from the *foreign* earnings of foreign subsidiaries (a construct that petitioner describes broadly as "foreign subsidiary dividends" (Pet. Br. 5-6 & n.5)) and dividends paid from the earnings of domestic subsidiaries (*ibid.*). Petitioner errs, however, in suggesting that its definitions draw a neat line between foreign and domestic commerce: (i) dividends paid by a domestic subsidiary may have their source in earnings from *foreign* commerce, but the dividends would still be deductible in determining the taxable income of the domestic corporation receiving those dividends (see note 20, *infra*); (ii) dividends paid by a foreign corporation may have their source in earnings from *domestic* commerce but, in at least some circumstances, would still *not* be deductible in determining the taxable income of the domestic corporation receiving those dividends (see note 8, *supra*). The differentiation in the treatment of dividends under the federal and Iowa statutes cannot smoothly be fitted into separate categories for domestic and foreign commerce.

[17] Nor is there evidence in this record of an actual discriminatory burden on foreign commerce, such as would exist in situations

If a domestic subsidiary earns income (whether from domestic or foreign activities), it is true that the dividends it pays to its parent are not taxed to the parent under the Iowa statute. But, under the Iowa scheme, the entire *earnings* of the subsidiary (whether from domestic or foreign activities) would be subject to state tax—by Iowa and other States—on an apportioned basis.[18] By contrast, only the portion of the foreign earnings distributed as dividends by the foreign subsidiary to the parent would be subject to state-level taxation, on an apportioned basis, under the Iowa scheme. By electing foreign incorporation of the subsidiary, the unitary business enterprise may thus achieve a benefit, rather than suffer a detriment, for the state-level tax then applies only to distributed dividends and not to all earnings derived by the foreign-incorporated subsidiary.[19]

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where foreign commerce is taxed more heavily than domestic commerce of the same type. See note 14, *supra*. Petitioner recites (Pet. Br. 9) that it received no domestic dividend income in 1981. It is not feasible on the record of this case to conduct a factual analysis of the relative burdens imposed by Iowa on foreign and domestic commerce even if one accepts the location of incorporation as a surrogate for the nature of the commerce involved.

[18] This discussion assumes that all States apply a tax scheme similar to that of Iowa. The States, in fact, differ widely in their tax treatment of income derived from the subsidiaries of a unitary business (see Pet. Br. 8-9 & nn.9-13). For example, California would tax an apportioned fraction of the entire earnings of a foreign subsidiary—even if it did no business in California—if the subsidiary were part of a unitary business enterprise that was subject to the California tax. See *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159 (1983). To determine whether Iowa's tax is *facially* discriminatory, however, it is relevant to observe how foreign and domestic commerce would fare if the Iowa scheme were applied by all States. See also note 29, *infra*.

[19] The brief of Amici Chevron, et al. (at 12-13) purports mathematically to illustrate the opposite conclusion. Amici candidly acknowledge, however, that their math "is somewhat simplified" (*id.* at 13 n.2). The most serious simplification in their analysis is that they neglect to account for the state-level tax that would be assessed on the entire *earnings* of the domestic subsidiary before it makes

3. Nor can it be said that the Iowa tax "facially discriminates" against corporations that elect to perform foreign commerce through use of foreign subsidiaries. Under the Iowa scheme, a domestic parent could establish a domestic subsidiary to act as the holding company for the stock of its foreign subsidiaries and to receive the earnings of those subsidiaries as dividends: if it did, the income received by the domestic holding company would be treated similarly by Iowa with income received by another domestic subsidiary that had conducted such commerce directly; moreover, any dividends paid by the holding company to the parent would be excluded from the parent's "taxable income" under federal law and the parent's "net income" under Iowa law.[20] Since the Iowa scheme allows the parent to elect a tax treatment for foreign subsidiary income that is identical to the tax treatment afforded to domestic subsidiary income, it cannot be said that Iowa "facially discriminates" against foreign subsidiaries, much less against foreign commerce.

This conclusion becomes even more apparent when one considers the three basic alternatives that a domestic parent corporation has for conducting the foreign commerce component of its unitary business: (i) the parent could conduct such foreign commerce directly, with the result that *all* of its earnings would be subject to appor-

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any distribution of dividends. Amici erroneously assume that it is appropriate to ignore the fact that the domestic subsidiary pays a state tax on its earnings in comparing the tax burden resulting from application of the Iowa scheme. In evaluating the alleged facial discrimination effected by the Iowa tax, it is not proper to ignore the operation of other provisions of the same statute. See *Halliburton Oil Well Cementing Co.* v. *Reilly*, 373 U.S. at 69.

[20] The earnings of the domestic holding corporation would be "subject to taxation" in the United States (26 U.S.C. 243(a)), even though the corporation would be entitled to seek a credit for the foreign taxes paid by its foreign subsidiaries. See 26 U.S.C. 11(a), 902. The dividends of the holding company to the parent would therefore be deductible in determining the taxable income of the parent corporation. See 26 U.S.C. 243(a).

tioned state taxation (see *Container Corp.* v. *Franchise Tax Board*, 463 U.S. at 166-169); (ii) the parent could form a domestic subsidiary to conduct such foreign commerce, with the result that *all* of the subsidiary's earnings (whether or not distributed as dividends to the parent) would be subject to apportioned state taxation (see *ibid.*); and (iii) the parent could form a foreign subsidiary to conduct such foreign commerce, with the result that *only those earnings distributed as dividends are subject to apportioned state taxation* under the Iowa scheme. It is not logical to view these options as describing a scheme that "facially discriminates" against foreign subsidiaries.[21]

In view of the virtually limitless variety of tax rates and practices applied in domestic and foreign jurisdictions, it would no doubt be possible to describe specific factual situations where the tax paid by the unitary business enterprise on the income of a domestic subsidiary would be less than the tax paid on the income of a foreign subsidiary under the Iowa scheme. The record of this case, however, provides no such examples. Moreover, such factual variations based upon the location of incorporation, rather than the location of the commerce involved, would not be constitutionally determinative. It is neither possible, nor constitutionally required, for a State to adopt a tax scheme that is perfectly neutral between foreign and domestic corporations in every conceivable factual application of its laws. It is sufficient that the state

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[21] Our discussion does not attempt to give account to local-level tax burdens that may be imposed in foreign nations. The record in this case fails to indicate even the existence, much less the nature, of such local-level foreign taxes (see Pet. Reply Br. In Support of Petition at 5-6). Nor is there any evidence to reflect the credits or reductions that foreign local governments would apply or allow. The record in this case is thus inadequate for examination of that topic, even if it were thought relevant. In evaluating the facial effect of the Iowa tax, however, it is evident that no discrimination against foreign-incorporated subsidiaries (much less foreign commerce) has been established.

scheme neither facially, nor actually, discriminates in a systematic fashion against foreign commerce.

4. While it is not critical to the constitutionality of the State's tax, we note that other provisions of the Iowa tax further mitigate the differential treatment that it affords to foreign and domestic subsidiary dividends. In particular, Iowa incorporates the federal practice of allowing a parent to deduct the foreign taxes it pays on dividends received from foreign subsidiaries. It is only, as in the present case, when the parent elects to take the federal tax credit for foreign taxes paid by itself or its subsidiary that it loses the federal deduction for taxes that it has paid on the foreign dividends. See 26 U.S.C. 275(a)(4); pages 3-4, *supra*. It is thus only when the parent elects the credit, instead of the deduction, that the result differs under the Iowa and federal schemes.[22]

B. The Iowa Tax Need Not Conform Precisely To The Federal Pattern

Although petitioner concedes at the outset (Pet. Br. 13) that Iowa is not constitutionally obligated to adhere to all of the specific features of the federal corporate tax scheme, the reasons why this is so are informative. It is, of course, the Internal Revenue Code, and not specific action of the Iowa legislature, that differentiates between dividends from domestic corporations and those from foreign corporations. In taxing an apportioned fraction of "net income," that it defines (with adjustments not at issue here) as federal "taxable income," Iowa accepts the results produced by the federal statute.

As this Court early pointed out, both Nation and State have power to tax. *Gibbons* v. *Ogden*, 22 U.S. (9 Wheat.) 1, 198-199 (1824). The "[c]oncurrent federal and state taxation of income" is thus "a well-established norm." *Mobil Oil Corp.* v. *Commissioner*, 445 U.S. 425, 448

[22] Petitioner's complaint against the Iowa tax thus reduces to the proposition that a credit, rather than a deduction, is required by the Constitution. There is no basis for such a contention. See *Container Corp.* v. *Franchise Tax Board*, 463 U.S. at 191-192 n.30.

(1980).[23] Under the Constitution, Congress has plenary power to tax and regulate, and even to discriminate against, "[c]ommerce with foreign Nations" (U.S. Const. Art. I, § 8, Cl. 3). But the action of Congress relevant to this case, and that of Iowa in following it in part, cannot properly be viewed as discrimination against foreign commerce.

Almost from the beginning of the federal income tax,[24] Congress has provided measures to prevent or minimize "the multiple taxation of corporate earnings as they passed from one corporation to another possibly within the same chain of beneficial ownership." 3 B. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 90.2.3, at 90-16 (1981).[25] Section 243 is the current provision,

[23] Section 6103(d)(1) of the Internal Revenue Code contemplates that the Internal Revenue Service will assist and cooperate with state taxing authorities for it authorizes and requires that "return information," as defined in Section 6103(b)(2), be open to inspection by, or disclosed to, state agencies charged with the administration of state tax laws. Cf. *Parker* v. *Brown*, 317 U.S. 341, 368 (1943).

[24] See War Revenue Act of 1917, ch. 63, § 206, 40 Stat. 305.

[25] The exclusion for domestic inter-corporate dividends is related to the long-standing discussions concerning proposals to integrate the federal corporate and individual income tax. In response to congressional direction, a recently published *Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once* (GPO 1992) has analyzed the costs and distortions produced by the so-called classical system of taxation that treats corporations and their investors as separtate entities and levies tax at each level. As the Report points out, "Because the double tax on corporate earnings distributed to shareholders might become a triple or quadruple tax if corporations were taxed in full on dividends from other corporations, a corporate shareholder is entitled to a full or partial dividends received deduction (DRD), depending on its percentage ownership of the distributing corporation." *Id.* at 153. The Report notes that most of our major trading partners have achieved some degree of integration. *Id.* at 159-184. The problems of integration, and the costs of non-integration, have long been the subject of tax reform discussions. See, *e.g.*, McClure, *Integration of the Personal and Corporate Income*

allowing a deduction for dividends received by a corporation from corporations subject to the federal income tax in the amount of 100% in the case of affiliated corporations, and (in 1981) 85% otherwise. See note 5, *supra*. The earnings at the domestic corporate level that produced the initial dividend are, of course, subject to the federal income tax, and it is on that basis that the deduction with respect to domestic inter-corporate dividend payments is allowed. See also note 8, *supra*. The deduction, therefore, reflects not exemption of domestic corporate earnings from the federal income tax on corporations, but rather the removal or reduction, as the case may be, of a substantial tax barrier to the existence of subsidiary corporations, or to the use of the corporate form for doing business generally.

In the case of dividends received from foreign corporations, however, the situation is different. Their earnings from foreign activities have not been currently subjected to taxation by the United States, and become

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Taxes: The Missing Element in Recent Tax Reform Proposals, 88 Harv. L. Rev. 532 (1975).

Both Nation *and* States have flexibility in determining how corporate income should be treated for purposes of income taxation. Under the first federal income tax provisions, the income of some corporations was taxed directly to shareholders, not to the corporations. See *Collector* v. *Hubbard*, 79 U.S. (12 Wall.) 1 (1870). Compare the current treatment of the so-called "S" corporations (26 U.S.C. 1361-1379), most of the income of which is taxed to shareholders, whether distributed or not. Under the modern income tax, this Court at one point appeared to believe that even without benefit of statute, a distribution of earnings by a subsidiary corporation to its parent did not constitute income taxable to the parent corporation. *Gulf Oil Corp.* v. *Lewellyn*, 248 U.S. 71 (1918). Until the Internal Revenue Code of 1954, the federal income tax consisted of a "normal" tax, usually at fixed relatively low rates, and a graduated surtax. Until the Revenue Act of 1936, ch. 690, 49 Stat. 1648, corporate dividends were not included in the normal tax income of individuals but only in income subject to the graduated surtax. See, *e.g.*, Sections 11, 12, and 25(a)(1) of the Revenue Act of 1934, ch. 277, 48 Stat. 684, 692. For current variety in state patterns, see Pet. App. 73a-75a.

subject to such taxation only if, when, and to the extent that they are paid out as dividends to United States taxpayers.[26] This differentiation is not discrimination against the dividends from foreign subsidiaries. If anything, it favors the foreign subsidiary, since all of the income of domestic subsidiaries (whether from domestic or foreign commerce) is taxed as earned, while the foreign earnings of foreign subsidiaries are ordinarily taxed by the United States only if, when, and to the extent that they are distributed as dividends to United States taxpayers. Although Congress has constitutional power to discriminate against foreign commerce, it has not done so by virtue of the deductions allowed by Sections 243 and 245 and the concurrent taxation of the dividends paid by foreign corporations to domestic corporations.[27]

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[26] There are some special and limited exceptions, such as foreign personal holding companies (Sections 551-558) and so-called "Subpart F" income of controlled foreign corporations (Sections 952-964) that receive special treatment. They are not involved in this case. The portion of the dividends from a foreign subsidiary that is distributed from earnings that are derived from commerce within the United States, and that are subject to tax within the United States, may also be excluded from the gross income of a domestic parent corporation. 26 U.S.C. 245(a)(3); see note 8, *supra*.

[27] Not only is this non-discrimination evident on its face, it is further indicated by the fact that most of the income tax treaties with our trading partners contain provisions against discrimination, as does the Model Income Tax Treaty (Treas. Dep't), June 16, 1981, Treas. Dep't, art. 24, *reprinted in* 1 Tax Treaties (CCH) ¶ 211, at 10,582. See, *e.g.*, Income Tax Convention, Sept. 26, 1980, U.S.-Can., art. XXV, T.I.A.S. No. 11,987, *reprinted in* 1 Tax Treaties (CCH) ¶ 1903, at 21,022; Income Tax Convention, Aug. 29, 1989, U.S.-F.R.G., art. 24, Treaty Doc. No. 10, 101st Cong., 1st Sess., *reprinted in* 2 Tax Treaties (CCH) ¶ 3249, at 28,163; Income Tax Convention, Apr. 17, 1984, U.S.-Italy, art. 24, T.I.A.S. No. 11,064, *reprinted in* 2 Tax Treaties (CCH) ¶ 4803.49, at 33,016. We have been informed by the State Department, the Treasury Department, and the Internal Revenue Service that they have received no complaints or protests from other nations against the concurrent operation of Section 243 of the Internal Revenue Code and the taxation of dividends from corporations of the nations with which we have income tax conventions containing non-discrimination provisions.

This same conclusion applies to the tax provisions of States, such as Iowa, that tax all of the earnings of domestic subsidiaries but tax only the portion of the foreign earnings of foreign subsidiaries that is distributed as dividends to the unitary business enterprise conducting operations in their States.[28] Since, under the Iowa scheme, the dometic subsidiary income is fully taxed domestically when earned, an exclusion for dividends upon distribution by domestic corporations avoids a double tax at the state level; since the foreign subsidiary income is not fully taxed domestically when earned, an exclusion is not necessary to avoid a double tax at the state level.[29] There is thus no discrimination against foreign-source income either by the federal government or by the States (including Iowa) that base their corporate income tax upon federal "taxable income."

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[28] Since petitioner's foreign subsidiaries paid aggregate dividends of $10,181,815 to petitioner in 1981, while petitioner received no dividends from domestic subsidiaries (or, as far as the record shows, from any domestic corporations), it seems obvious that Iowa's corporate income tax did not deter petitioner from investing in and carrying on commercial activity abroad. Nor did it discriminate against non-existent domestic dividend income.

[29] See also note 8, *supra*. Nor does a double tax result at the state level because, for example, California applies an apportioned tax to the *earnings* of the foreign subsidiary that is part of the unitary business (see note 8, *supra*), while Iowa applies an apportioned tax only to the distributed portion of those earnings. The result, instead, favors the foreign subsidiary because less than its entire income may be taxed under the Iowa scheme.

The fact that five States have no corporate income tax on either domestic or foreign corporations (see [1 All States] State Tax Guide (CCH) ¶ 10-060, at 1026 (Dec. 31, 1990)) does not alter this conclusion. It only reduces further the tax burdens on all corporations.

C. *Japan Line, Ltd.* v. *County of Los Angeles* Does Not Prohibit State Taxation of Dividends That A Domestic Corporation Receives From A Foreign-Incorporated Subsidiary

By referring to this Court's decision in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979), petitioner appears to suggest (Pet. Br. 13-14, 15 n.17, 21-22) that, in view of the possibility of multiple taxation of the earnings of foreign-incorporated subsidiaries, Iowa should be required to abstain from taxing its apportioned share of foreign-source dividends. An argument to that effect was advanced somewhat more explicitly in *Mobil Oil Corp.* v. *Commissioner*, 445 U.S. 425 (1980), on facts precisely paralleling the facts of this case, and was explicitly rejected (*id.* at 446-449), along with other arguments challenging the power of a State to impose a corporate income tax upon the fraction of foreign-source dividends apportioned to it.

Generally, as a commercial enterprise expands internationally, it runs some risk of multiple claims of power to tax. Separate incorporation may reduce, but is unlikely to eliminate, the possibility of multiple taxation. Internally, within the United States, the requirements for apportionment imposed by decisions of this Court resolve the most troublesome of multiple claims to tax. The United States has also sought to reduce the burdens of multiple taxation upon its citizens and domestic corporations by means of the deduction for foreign income taxes allowed by Section 164(a)(3), or, at the election of the taxpayer, the credits for foreign income taxes allowed by Sections 901 and 902.

As we have noted, "[c]oncurrent federal and state taxation of income" is the "well-established norm." *Mobil Oil Corp.* v. *Commissioner*, 445 U.S. at 448. Petitioner accordingly raises no question concerning the fact that it normally pays annual income taxes to the federal government and, concurrently, to the States in which it does business (including Iowa) on income apportioned to the several States. When we look to petitioner's foreign

subsidiaries, the foreign nation in which the subsidiary is organized and does business is the sovereign and, as such, stands in the place of the United States and can be expected to tax income earned within its borders. The burdensomeness of its taxation is, of course, a factor that petitioner took into account in deciding to expand its operations into that nation. As income is earned in the foreign nation, neither the United States nor Iowa seeks to tax it.

When, however, the foreign subsidiary declares a dividend from its foreign earnings (see note 8, *supra*), the possibility of multiple taxation beyond the usual norm arises. Petitioner, a United States taxpayer, will have received a dividend includible in its gross income pursuant to Section 61(a)(7), *not* giving rise to a deduction under Section 243, and therefore included in its taxable income as defined in Section 63(a), subject to federal income tax, and, as "net income" for Iowa purposes, to Iowa's corporate income tax upon a properly apportioned fraction. That, of course, is not the end. The foreign nation is likely (as we do in Sections 1441 and 1442 of the Internal Revenue Code) to regard a dividend declared by one of its corporations as income to the recipient having a source within its borders and, if the recipient is not one of its nationals, subject to withholding.

It is in precisely that situation that it is the legislated policy of the United States, in the interest of its citizens and enterprises, to yield to some extent its power to tax and to allow its recipient taxpayer to take a deduction from gross income in the amount of the foreign income taxes paid, pursuant to Section 164(a)(3) or, at its election, to take a credit, pursuant to Sections 901 and 902, against its federal income tax for the foreign income taxes paid. That leaves, in this case, Iowa and the foreign nation as concurrent taxing powers, just as Iowa and the United States would be in the case of domestic income. There is no basis for the somewhat oblique sug-

gestions of petitioner and its amici[30] that Iowa should be required to grant a credit for foreign taxes paid simply because, to mitigate double taxation at the national level, the United States has chosen to do so. See *Container Corp.* v. *Franchise Tax Board*, 463 U.S. at 191-192 n.30.

If petitioner had chosen to take the deduction allowed by Section 164(a)(3), that would have reduced its federal "taxable income" and its Iowa "net income" by the amount of the foreign income taxes paid. Presumably in its own self-interest, it chose to take the credit rather than the deduction (Pet. App. 32a), leaving its federal "taxable income" and its Iowa "net income" unreduced. Since the record does not show the fraction of petitioner's "net income" that was apportioned to Iowa, we do not know the amount by which its Iowa taxes would have been reduced had it chosen the deduction. In any event, it was petitioner's choice, not Iowa's, that its Iowa "net income" remained unreduced by the amount of foreign taxes paid with respect to the dividends it received from foreign subsidiaries.

II. THE IOWA TAX DOES NOT VIOLATE THE EQUAL PROTECTION CLAUSE

Petitioner argues (Br. 24-30) that the Iowa tax discriminates against foreign commerce in a manner that violates the Equal Protection Clause. Since, as we have discussed, the Iowa tax does not discriminate against foreign-incorporated subsidiaries (much less against foreign commerce), there is no violation either of the Commerce Clause or of the Equal Protection Clause. The different treatment of dividends received from foreign-incorporated subsidiaries, as compared to those from domestic-incorporated subsidiaries, serves legitimate, rational state purposes. See Pet. App. 9a-10a; pages 9-23, supra. It therefore does not deny petitioner the equal

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[30] See Pet. Br. 6-7 & nn.7, 8; Amici Avon Products, et al., Br. 3 n.2; Amici Chevron, et al., Br. 13 & n.2.

protection of the laws. See *Amerada Hess Corp.* v. *Director*, 490 U.S. at 80; *Metropolitan Life Ins. Co.* v. *Ward*, 470 U.S. 869, 881 (1985).

CONCLUSION

The judgment of the Supreme Court of Iowa should be affirmed.

Respectfully submitted.

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OCTOBER TERM, 1991

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v.
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Respondent.

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STATEMENT OF INTEREST [1]

Amici are domestic multinational companies that participate extensively in foreign commerce. Although *amici* represent different industries, they share certain interests. First, each of these businesses has one or more foreign subsidiaries, and when those subsidiaries declare dividends, they are subject to, or potentially subject to, the type of discriminatory treatment imposed by Iowa on Petitioner Kraft in this case.

[1] The parties' letters of consent have been filed with the Clerk pursuant to Rule 37.3 of this Court.

Additionally, as large enterprises with longstanding overseas commitments, *amici* have an abiding interest in the protections of the foreign commerce clause and the equal protection clause. In this increasingly competitive and global marketplace, the Constitution's protection against parochial and misguided discriminatory treatment of foreign commerce takes on special importance.

SUMMARY OF ARGUMENT

The commerce clause issues in this case boil down to two simple questions: may a state discriminate against foreign commerce, provided only that it does not advance purely local interests as a result? And may asserted "administrative convenience" justify a state law that facially discriminates against foreign commerce?

The State of Iowa insists that its discrimination against foreign commerce is not invidious under the foreign commerce clause because it does not favor local interests at the expense of their foreign competitors. This theory is untenable: the purpose of the foreign commerce clause (U.S. Const. art. I, § 8, cl. 3) is to prevent state interference with commerce among nations, and the burden of discriminatory legislation is not lightened in any way by the State's pursuit of a discriminatory objective that benefits domestic commerce as a whole. Furthermore, facial discrimination against foreign commerce cannot be justified absent the State's demonstration that it has important ends which cannot be served through other, nondiscriminatory means. Certainly, mere speculative claims of administrative convenience cannot save the Iowa statutory scheme from invalidation.

Nor is administrative convenience sufficient to satisfy the requirements of the equal protection clause (U.S. Const. amend XIV, cl. 1), even under the least substantial scrutiny. At issue here is what amounts to a claim that the administrative convenience of retaining the current

version of the Iowa tax form justifies the discrimination. This Court has never held that a state's unwillingness to alter its tax form is adequate justification for preferring one class of taxpayers over another. Even if the taxing scheme could pass rational basis scrutiny, which we think it could not, a higher level of scrutiny is appropriate here, where a facially discriminatory statute implicates foreign commerce—a clear constitutional concern. A close look is particularly appropriate when, as here, state legislators are not politically accountable to those who must bear the burden of the discriminatory tax.

ARGUMENT

Under the Iowa taxing scheme, the State of Iowa borrows heavily, although not entirely, from the federal Internal Revenue Code. Under the Code, to arrive at net income a taxpayer deducts a certain percentage of dividends received from *domestic* subsidiaries: if the taxpayer owns 80 percent or more of a domestic subsidiary, it is allowed a 100 percent tax deduction for the dividends received from these "affiliated" subsidiaries. 26 U.S.C. §§ 243, 1504 (1988), *as amended by* Pub. L. 101-508, 104 Stat. 1388 (1990). Under the Code, taxpayers claim a credit for the taxes paid on dividends received from foreign subsidiaries. 26 U.S.C. §§ 901, 902.[2]

Iowa's Tax Code imports the federal Code's definition of "net income," thereby excluding from the state's income tax base all dividends received from "affiliated"

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[2] The federal Code (26 U.S.C. § 164(a)(3) (1988)) permits a taxpayer to elect to treat tax on foreign source income as a deduction instead of as a credit in some circumstances. *See* Opp. 1; Pet. App. 31a. Although a taxpayer electing to deduct foreign taxes paid would, due to Iowa's importation of the federal "net income" figure, reduce the discriminatory effects at the state level, the costs at the federal tax level could be very high. Joseph Isenbergh, I *International Taxation* ¶ 17.1.1 (1990). In effect, Iowa offers reduced discrimination only if a taxpayer elects to sacrifice substantial rights under federal law.

domestic subsidiaries, but *including* all foreign-source dividends. Iowa Code Ann. § 422.35 (West 1990 & Supp. 1991). Although the Iowa Tax Code provides a number of credits and other adjustments to net income, Iowa does not (unlike the federal Code) allow a credit for taxes paid to foreign countries. This results in discriminatory treatment of foreign-source income in violation of the foreign commerce and equal protection clauses.

The complexities of the tax statutes, both at the federal and state levels, should not be allowed to obscure the practical essence of this case. The discrimination against foreign commerce effected by Iowa's tax scheme is stark. When a corporate taxpayer receives dividends from a *domestic* corporation, Iowa law, as a general matter, does not tax the recipient at all on those dividends, or taxes only a small fraction. When an otherwise identically situated corporate taxpayer receives dividends from a *foreign* corporation, the dividends are taxable in full. It is as if Iowa simply imposed a tariff on the receipt of dividends from sources outside the United States. If this policy is sensible from the standpoint of this country's national interests, the decision to implement such a policy is a matter for the federal government, not the State of Iowa.

I. IOWA'S TAX TREATMENT OF FOREIGN-SOURCE INCOME IMPERMISSIBLY DISCRIMINATES AGAINST FOREIGN COMMERCE

Iowa asks this Court to expand states' ability to interfere with foreign commerce by ruling first, that Iowa may permissibly discriminate against such commerce so long as it does not advance purely local interests in the balance, and second, that administrative convenience can justify a state law that facially discriminates against foreign commerce. The Court should decline the invitation to alter its prevailing jurisprudence.

The State concedes that its tax provisions treat dividends of foreign subsidiaries differently from dividends

of domestic subsidiaries, and essentially concedes that this works actual discrimination against unitary businesses that receive dividends from foreign subsidiaries. Opp. 10.[3] The State argues, however, that it may permissibly discriminate against foreign commerce as long as "[t]here is no direct commercial advantage to local Iowa business at the expense of non-Iowa business" as a result. Opp. 10.[4] The court below adopted this curious theory,[5] but the test founders because it takes no account of the purpose and practical effect of the foreign commerce clause, which prevents state interference with foreign commerce *regardless* of whether purely parochial interests are advanced by discriminating against such commerce.

This Court has long acknowledged that one "compelling reason" for the Constitutional Convention of 1787 was that, under the Articles of Confederation, "the individual States [were] free to burden commerce both among themselves *and with foreign countries* very much as they pleased." *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 283 (1976) (emphasis added). As Chief Justice Marshall wrote from experience as an eyewitness,

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[3] The State does not contest Kraft's demonstration that "Iowa subjects a corporation receiving a $100,000 foreign subsidiary dividend to a greater tax than an otherwise similarly situated corporation receiving a $100,000 domestic subsidiary dividend" (Pet. 6), and the State's own hypotheticals demonstrate that its tax statutes create a "difference in treatment of the dividends" of foreign and domestic subsidiaries, and that this creates a "corresponding difference in treatment of" two otherwise similarly situated unitary businesses. Opp. 10.

[4] *See also, e.g.*, Opp. 11 (because Iowa's discriminatory treatment of foreign-source dividends "does not favor Iowa activities over those which cross state lines and does not encourage or protect the conduct of activities in Iowa, the Iowa tax structure does not discriminate against foreign commerce in violation of the Commerce Clause").

[5] "Kraft must show, as in the case of alleged interstate discrimination, that Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme." Pet. App. 7a.

> The oppressed and degraded state of commerce previous to the adoption of the constitution can scarcely be forgotten. It was regulated by foreign nations with a single view to their own interests; and our disunited efforts to counteract their restrictions were rendered impotent by want of combination.

Brown v. Maryland, 25 U.S. (12 Wheat.) 419, 445-46 (1827).

To address these evils, which had prevented the formation of a coherent nation out of disparate parts, the Framers provided that the national government should have substantial control over both interstate and foreign commerce. *H.P. Hood & Sons v. DuMond*, 336 U.S. 525, 533-35 (1949). Inherent in this affirmative grant of authority is an implied limitation on state interference with commerce involving business beyond state borders. *Id.* at 535. The interstate commerce clause[6] prevents states from interfering with the free flow of goods among the states, and invalidates state laws that favor local interests at the expense of interstate businesses. "[W]hat is ultimate is the principle that one state in its dealings with another may not place itself in a position of economic isolation." *Baldwin v. Seelig*, 294 U.S. 511, 527 (1935).

The foreign commerce clause,[7] in turn, prevents states from interfering with commerce among the nations by "burden[ing] commerce . . . with foreign countries very much as they please[,]" *Michelin*, 423 U.S. at 283, and allows the nation to avoid "disunited efforts" when addressing commerce with other countries. *Brown*, 25 U.S. (12 Wheat.) at 445-46. "Those who felt the injury arising from this state of things [prior to adoption of the

[6] "The Congress shall have the Power . . . To regulate Commerce . . . among the several States . . . ." U.S. Const. art. I, § 8, cl. 3.

[7] "The Congress shall have the Power . . . To regulate Commerce with foreign Nations . . . ." U.S. Const. art. I, § 8, cl. 3.

Constitution], and those who were capable of estimating the influence of commerce on the prosperity of nations, perceived the necessity of giving the control over this important subject to a single government." *Id.* at 446.[8] It is against this backdrop of heightened constitutional concern over relations with foreign nations that the propriety of state taxing actions must be assessed.

A. Under the Foreign Commerce Clause, the Proper Subject of Inquiry Is Whether a State Law Discriminates Against Foreign Commerce in Favor of Domestic *or* Local Interests

The foreign commerce clause theory adopted by the court below is based on two premises: only discrmination that is demonstrated to favor local commerce violates the *interstate* commerce clause; and the same showing of local benefit at foreign expense is required under the *foreign* commerce clause. Pet. App. 7a. Based on these assumptions, the court below found that Iowa's discrimination against foreign commerce was not invidious, because the tax scheme did not directly benefit purely local interests.

Both premises, however, are mistaken. First, a showing of purely local benefit is *not* the *sine qua non* of invidious discrimination—even against interstate commerce. Instead, any state statute that facially discriminates

[8] Indeed, the foreign commerce clause is only one of many provisions restricting state power over foreign affairs. Compare, *e.g.*, U.S. Const. art. I, § 8, cl. 1 (Congress has power to collect "Duties" and "Imposts") with *id.* art. I, § 10, cl. 2 (prohibiting states from "lay[ing] any Imposts or Duties on Imports or Exports," except for purposes of inspection, without congressional consent); *see also, e.g., id.* art. II, § 2, cl. 2 (President has the authority to make treaties with foreign nations (with the advice and consent of the Senate)) and *id.* art. I, § 10, cl. 1 (prohibiting states from entering into any "Treaty, Alliance, or Confederation"); *id.* art. I, § 10, cl. 3 (prohibiting states from, *inter alia*, laying duties of tonnage or entering into agreements or compacts with other states or countries, without congressional assent).

against interstate commerce is presumptively invalid: "facial discrimination by itself may be a fatal defect, regardless of the State's purpose . . . . At a minimum such facial discrimination invokes the strictest scrutiny of any purported legitimate local purpose and of the absence of nondiscriminatory alternatives." *Hughes v. Oklahoma*, 441 U.S. 322, 337 (1979).

This Court has made it quite clear that state statutes which facially discriminate against interstate commerce are subject to the most exacting scrutiny, regardless of whether they favor local businesses relative to their interstate competitors. "When a state statute directly regulates or discriminates against interstate commerce, *or* when its effect is to favor in-state economic interests over out-of-state interests, we have generally struck down the statute without further inquiry." *Brown-Forman Distillers v. N.Y. Liquor Authority*, 476 U.S. 573, 579 (1986) (emphasis added).[9]

Furthermore, even if a demonstration of local benefit were necessary in order to render discrimination against interstate commerce invidious and impermissible, such a showing is not necessary—and indeed makes very little sense—under the *foreign* commerce clause.[10] The Iowa

[9] *See also, e.g., Hughes v. Oklahoma*, 441 U.S. 322, 337 (1979); *Armco Inc. v. Hardesty*, 467 U.S. 638, 644 (1984) (rejecting the state's contention that the Court should require Armco to prove that the state's tax "results in a total burden higher than that imposed on Armco's competitors in" the state); *Philadelphia v. New Jersey*, 437 U.S. 617, 626 (1978) (rejecting as irrelevant New Jersey's claim that "no New Jersey commercial interests stand to gain advantage over competitors from outside the state" because of the State's discriminatory ban on importation of out-of-state solid and liquid waste).

[10] In each case on which the State relies, this Court was applying the *interstate* commerce clause, which was designed to counteract the interstate protectionism that had occurred prior to the adoption of the Constitution. *Supra* p. 6. When a state statute impermissibly discriminates against interstate commerce, the statute almost invariably confers a local benefit at the expense of interstate commerce. *See, e.g., Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 268 (1984); *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 329 (1977).

supreme court failed to recognize that the interstate commerce clause and foreign commerce clause have different objects (*supra* pp. 6-7), and therefore condemn different types of discrimination.

When a business engaged in foreign commerce shoulders the burden of discriminatory taxation and alters its behavior to the detriment of such commerce, it is of no moment that the discrimination does not benefit local businesses. And a state's wrongful interference with the free flow of foreign commerce is not lessened in the least if state law benefits domestic commerce generally, instead of local interests specifically. Therefore, when this Court has evaluated state laws that discriminate against foreign commerce, it has not focused on whether purely local interests have been advanced by the law.

In *Cook v. Pennsylvania*, 97 U.S. 566 (1878), for example, the Court invalidated statutes that imposed selective taxation on goods of foreign growth or manufacture sold at auction. The Court noted that the effect of the laws was that by the first statute "a discrimination of one-fourth of one per cent is made against foreign goods sold at auction" relative to domestic goods, and that by the second statute, "while all sales of foreign or imported goods [were] taxed, those arising from groceries, goods, wares, and merchandise of American growth or manufacture [were] exempt from such tax." *Id.* at 569-70. The Court found that this discrimination against foreign commerce in favor of domestic goods was impermissible: "If a tax assessed by a State injuriously discriminating against the products of a State of the Union is forbidden by the Constitution, a similar tax against goods imported from a foreign State is equally forbidden." *Id.* at 573.

And in *Hale v. Bimco Trading, Inc.*, 306 U.S. 375 (1939), a Florida statute imposing an inspection and fee

on cement imported from foreign countries, but exempting domestic cement, was also found to violate the foreign commerce clause. This Court noted that it had been given "no reason resting in local conditions for what appears to be a transparent discrimination in the imposition of heavy inspection fees as between imported and domestic cement . . . ." *Id.* at 380. Thus, the Court unanimously concluded that such "discrimination against foreign commerce" was repugnant to the foreign commerce clause: "[s]uch assumption of national powers by a state has, ever since March 12, 1827 (*Brown v. Maryland*, 12 Wheat. 419), been found to be in collision with the Constitution." 306 U.S. at 380.

Iowa's theory is not only inconsistent with authority, but also with the inherent logic of the foreign commerce clause. Curiously, under the theory adopted below, the more a state sought to act as an arbiter of United States foreign commerce by purporting to advance non-local domestic or national economic interests, the greater its power would be to permissibly discriminate against foreign commerce. Thus, contrary to logic, the more *national* the state's concerns advanced through discriminatory legislation, the less it would risk impermissibly interfering with the federal government's power to regulate foreign commerce. Under this convoluted approach, Iowa could tax foreign-source dividend income at a rate ten times greater than domestic-source dividend income in order to foster *domestic* industry generally, since it would not directly advance purely parochial interests. Yet the State's protectionist approach is as equally served by the theory that a rising tide raises all ships as it is by legislation directed exclusively toward local business.

If this Court were to find that states are free to discriminate against foreign commerce so long as local interests are not thereby advanced, it would signal a substantial retreat from the consistent protection this Court has afforded foreign commerce. *See Japan Line,*

Ltd. v. County of Los Angeles, 441 U.S. 434 (1979).[11] The only correct approach—applied by this Court in the *Cook* case, *supra*—is that state taxes that discriminate against foreign commerce violate the foreign commerce clause, whether or not purely local interests are favored by the discrimination.[12]

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[11] In *Japan Line*, the Court held that when a state tax is examined under the foreign commerce clause, "a more extensive constitutional inquiry is required" than in interstate commerce clause cases, even if—as was the case in *Japan Line*—the state statute does not discriminate against foreign commerce. 441 U.S. at 445. The Court found that when foreign commerce is at stake, it must also inquire whether the "enhanced risk of multiple taxation" and the possibility that the state tax "may impair federal uniformity in an area where federal uniformity is essential" require invalidation of the tax at issue. *Id.* at 446, 448. Under this more rigorous test, the tax in *Japan Line* failed to pass constitutional muster *despite* its nondiscriminatory character. *Id.* at 444, 448.

[12] The United States argued in its brief at the petition stage that Iowa's discriminatory treatment of foreign-source income "does not necessarily imply that the total income stream of a foreign subsidiary is subjected by Iowa to a greater or lesser total tax burden than that of a domestic subsidiary of the same unitary enterprise." Brief for the United States as *Amicus Curiae* at 9. The United States speculated that the interaction of Iowa's taxing scheme with those of other jurisdictions may in fact place a greater aggregate tax burden on "domestic corporate income" than on foreign-source income. *Id.* at 9 n.9. That inquiry, however, is irrelevant: this Court has noted that "[its] conclusion that a tax facially discriminates against interstate commerce need not be confirmed by an examination of the tax burdens imposed by other States . . . ." *Tyler Pipe Industries v. Washington Dept. of Revenue*, 483 U.S. 232, 247 (1987).

Finally, mere speculation is *all* this Court has been offered in defense of the State's tax scheme: neither the State nor the United States has demonstrated that the State's facially discriminatory tax scheme *actually* imposes no net discriminatory burden on foreign commerce.

B. The State's Rationale for Discriminating Against Foreign Commerce Fails To Approach the Level of Justification Required To Save Discriminatory State Laws

The State alternatively argues that its discriminatory treatment of foreign-source income can be justified by administrative convenience. Opp. 17. But again the State's analysis is flawed. Under *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269 (1988), upon which the State relies, as well as *Limbach*'s predecessors, the State's purported justification for discriminating against foreign commerce cannot pass constitutional muster.

The State's selective quotation from *Limbach*, that "state statutes that clearly discriminate against interstate commerce are routinely struck down . . . unless the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism . . . ." (Opp. 16), omits two important aspects of the Court's test of justifications that would save discriminatory laws. Both are fatal to the State's argument.

First, the *Limbach* Court noted that "the standards for such justification [of discriminatory laws] are high." 486 U.S. at 278. In fact, the Court noted in *Limbach* that "'facial discrimination by itself may be a fatal defect' and '[a]t a minimum . . . invokes the strictest scrutiny.'" *Id.* at 279 (quoting *Hughes v. Oklahoma*, 441 U.S. at 337). Thus, this Court has invalidated discriminatory state laws despite claims that the discrimination was justified by many important state interests including, *inter alia*, promoting the sanitation of milk or meat products,[13] protecting consumers against banking fraud and financial instability,[14] preventing consumer confusion,[15] and conserving natural resources.[16] In fact, our research has disclosed only one case in which a state law has met the *Limbach* test. In *Maine v. Taylor*, 477 U.S. 131, 141, 143 (1986), a ban on importation of live baitfish was upheld because the State *proved* that its wild fish could be infected by parasites common only in out-of-state baitfish, that its aquatic ecology could be disturbed by inadvertent importation of other non-native species of fish along with out-of-state baitfish, *and* that "less discriminatory means of protecting against these threats were currently unavailable."

Compared to the host of important state interests that this Court has deemed insufficient to save discriminatory state laws, Iowa's justification for discriminatory treatment of foreign-source income is weak indeed. Iowa justifies its discrimination as "a byproduct" of its decision to utilize federal tax returns "as the starting point for computation of net income for Iowa tax purposes." Opp. 17. Reference to a taxpayer's federal tax return is convenient and inexpensive, the State argues. *Id.*

The court below accepted this argument, stating that the State's discrimination was permissible because

> [t]he taxpayer is permitted to merely lift the figures off the federal return and transfer them to the Iowa franchise tax return . . . . [The Iowa scheme] prevents the taxpayer from spending time and money on complex forms, provides a saving to the state, allows the state to rely on federal regulation and interpretation, and provides the state with an inexpensive and quick way of verifying the accuracy of taxpayers' returns.

Pet. App. 9a-10a.

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[13] *Dean Milk Co. v. Madison*, 340 U.S. 349 (1951); *Minnesota v. Barber*, 136 U.S. 313 (1890).

[14] *Lewis v. BT Investment Managers, Inc.*, 447 U.S. 27 (1980).

[15] *Hunt v. Washington Apple Advertising Comm'n*, 432 U.S. 333 (1977).

[16] *Hughes v. Oklahoma*, 441 U.S. 322 (1979); *Philadelphia v. New Jersey*, 437 U.S. 617 (1978).

But this Court has made it abundantly clear that mere administrative convenience is insufficient to protect a discriminatory state law against challenge. "State restrictions inimical to the commerce clause should not be approved simply because they facilitate in some measure enforcement of a valid tax." *Toomer v. Witsell*, 334 U.S. 385, 406 (1948); *see also, e.g., Halliburton Oil Well Cementing Co. v. Reilly*, 373 U.S 64, 74 n.9 (1963) (rejecting administrative convenience as justification for discrimination against out-of-state companies); *Hunt v. Washington Apple Advertising Comm'n*, 432 U.S. 333, 354 n.9 (1977) (rejecting State's contention that burdens imposed on interstate commerce by apple labeling regulation were justified "on the ground that the standardization required by the statute serves the national interest in achieving uniformity in the grading and labeling of foodstuffs").

Iowa seeks some special protection in the fact that it has borrowed portions of the federal tax code. However, just as this Court has noted that "[a]bsent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States" (*Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 448 (1980)), a state's *adoption* of provisions from the "federal level" as its own does not insulate the laws from scrutiny under the foreign commerce clause. And picking and choosing from the federal statute so as to work facial discrimination against foreign commerce, as Iowa has done here, cannot gain credibility from the source of the materials.[17]

[17] Moreover, it is incorrect for Iowa to imply that, in discriminating against dividends from foreign corporations, Iowa is simply mimicking federal law. The provisions of federal law that subject dividends from foreign, but not domestic, subsidiaries to federal taxation have meaning only in the context of those *other* provisions of federal law that provide United States corporations with a credit for foreign taxes paid by their subsidiaries. This credit is designed precisely to eliminate the harsh treatment of foreign corporations that would otherwise result. Iowa law contains no such mechanism. Of course, even if it were true that Iowa simply mimicked federal law in discriminating against income from foreign commerce, this fact would be of no moment. Although the federal government may be free to discriminate against foreign commerce if it wishes to do so, a state government is not.

The State's justification here also fails the second test of *Limbach*: the State must prove that its legitimate interests "cannot be adequately served by reasonable nondiscriminatory alternatives." *Limbach*, 486 U.S. at 278; *Hughes v. Oklahoma*, 441 U.S. at 336; *Hunt*, 432 U.S. at 353. The State has not even attempted to demonstrate that its adoption of a portion of the federal tax code actually promotes administrative convenience, and that this goal could not be achieved without discriminating against foreign commerce. As discussed below, *infra* p. 18, the State's highly speculative interest in administrative convenience does not withstand even the slightest inquiry.

II. THE IOWA TAX TREATMENT VIOLATES THE GUARANTEES OF THE EQUAL PROTECTION CLAUSE

Even if Iowa's taxing scheme did not violate the foreign commerce clause, it would still run afoul of the equal protection clause.[18] The equal protection clause is designed to assure that "all persons similarly circumstanced shall be treated alike." *Royster Guano Co. v. Virginia*, 253 U.S. 412, 415 (1920). Iowa treats companies that earn dividends from foreign subsidiaries in a

[18] "Equal protection restraints are applicable even though the *effect* of the discrimination . . . is similar to the type of burden with which the Commerce Clause also would be concerned." *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869, 881 (1985) (emphasis in original). The two clauses have different functions. The foreign commerce clause protects international commerce, while the equal protection clause protects persons and corporations from unconstitutional discrimination by the states. *Id.*

manner different from—and more harshly than—companies that earn dividends from domestic subsidiaries, creating an unconstitutional classification. The court below held that Iowa's claim of "administrative convenience" justified the discriminatory treatment of foreign source income, but that conclusion is untenable.

A. Even Assessed Under a Rational Basis Standard, the Iowa Business Tax Violates the Equal Protection Clause

In assessing whether disparate treatment in a taxing scheme violates the equal protection clause under rational basis scrutiny, the "classification 'must rest upon some ground of difference having a fair and substantial relation to the object of the legislation.'" *Allied Stores of Ohio v. Bowers*, 358 U.S. 522, 527 (1959) (quoting *Royster Guano Co. v. Virginia*, 253 U.S. at 415). The classification here is, of course, whether the dividend income is domestic or foreign. The object of the legislation, it is claimed, is administrative convenience.

This justification, however, cannot satisfy even the most minimal level of scrutiny under an equal protection analysis. In equal protection cases upholding discriminatory taxes on the ground of "administrative convenience," the burdens at stake have gone well beyond altering a tax form. For example, in *Fernandez v. Weiner*, 326 U.S. 340 (1945), this Court rejected a challenge to an estate tax on community property that did not reach non-marital arrangements. There, "administrative convenience" justified "imposing a tax on a well recognized and defined class" and not extending it "so as to embrace a penumbra of special and more or less casual interests in which each case may or may not resemble the taxed class." *Id.* at 360-61.

Administrative convenience may also justify taxes that apply, for example, only to businesses employing more than a particular number of employees. *See Carmichael v.*

Southern Coal & Coke Co., 301 U.S. 495, 510-512 (1937). In addition to noting that this sort of distinction is commonplace in the law (*id.* at 510), the Court recognized that "the expense and inconvenience of collecting the tax from small employers [might well be] disproportionate to the revenue obtained." *Id.* at 511. No similar benefit is alleged to exist here, and the benefit that actually is claimed is inconsequential.

In *WHYY v. Glassboro*, 393 U.S. 117 (1968) (per curiam), this Court struck down a state tax classification under equal protection in the face of a claim similar to Iowa's assertion of "administrative convenience." There, New Jersey denied out-of-state nonprofit corporations the tax exemptions accorded to in-state nonprofit corporations. A claim of "administrative convenience" could not legitimize this discrimination—New Jersey had only to provide an out-of-state corporation "an opportunity equivalent to that of a domestic corporation to demonstrate that it meets the requirements for a nonprofit corporation under local law." *Id.* at 120.

In this case, as in *WHYY v. Glassboro* above, any perceived administrative burden would be eliminated simply by treating unitary businesses alike, regardless of the situs of the subsidiary providing dividend income. And that equality of treatment is hardly difficult to achieve. In Iowa, the use of federal taxable income is only the beginning of arriving at taxes owed. From that figure, thirteen separate adjustments are made to determine the proper tax base for Iowa purposes. Iowa Code Ann. § 422.35 (West 1990 & Supp. 1991). Iowa has provided no reason why another—for foreign dividend treatment—cannot be added to achieve equal treatment of foreign- and domestic-source income. Iowa's "administrative convenience" argument is especially contrived in the current instance. The tax treatment at issue applies only to corporate taxpayers holding interests in corporate subsidiaries abroad. The State has not demonstrated that the

number of such tax returns is significant, particularly in relation to the total number of tax returns filed in Iowa each year.

What Iowa's claim of administrative convenience amounts to is its unwillingness—for no apparent reason—to alter its existing tax form. We are aware of no decision of this Court finding a state's interest in using a particular tax form sufficient to justify blatant discrimination. Indeed, if such minimal justification sufficed to uphold a discriminatory tax, then there would be virtually no circumstance under which a tax could ever be held unconstitutional under the equal protection clause. It is always easier for state taxing authorities to maintain the status quo and to continue using established forms than to reprint the forms and eliminate the discrimination. Indeed, this Court has invalidated a taxing scheme that precluded out-of-state property owners from demonstrating their nonprofit status,[19] but certainly limiting the number of nonprofit forms the state must process would be more convenient for the state.

In fact, the purported justification of administrative convenience in this case is so insubstantial that it borders on the pretextual. What really appears to be involved here is Iowa rather plainly favoring domestic commerce over foreign commerce—"the very sort of parochial discrimination that the Equal Protection Clause was designed to prevent." *Metropolitan Life Insurance Co. v. Ward*, 470 U.S. 869, 878 (1985). Although the federal government, due to its power over foreign commerce, may have a substantial and permissible basis for discriminating between foreign and domestic subsidiaries, the states do not. In *Metropolitan Life*, this Court made plain that under the equal protection clause, states cannot favor domestic over foreign business. *Id.* at 883. Iowa is therefore precluded from articulating this rationale for its facially discriminatory treatment of foreign-source income, leaving it only the claim of administrative convenience. Here, as in *WHYY*, this administrative convenience rationale is plainly insufficient.[20]

[19] *See WHYY v. Glassboro*, 393 U.S. 117 (1968).

B. State Tax Schemes that Distinguish Between Domestic and Foreign Sources of Dividend Income Are Subject to a Closer Look Under the Equal Protection Clause

Even if the Iowa scheme could withstand Kraft's equal protection claim under rational basis scrutiny, the Court should take a closer look. This conclusion is required due to the nature of the constitutional right at stake and the related inability of ordinary political processes to redress this unfair discrimination. When viewed in this light, Iowa's scheme is clearly impermissible.

While states are ordinarily accorded wide latitude in determining what and how to tax (*see Ohio Oil Co. v. Conway*, 281 U.S. 146, 159 (1930)), this Court has long made clear that a close judicial look is required where a discriminatory taxing scheme implicates other constitutional rights. Thus, in *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356 (1973), for example, it was appropriate to measure under the rational basis standard a state tax on personal property that applies to corporations, but not individuals, only because "no specific federal right, apart from equal protection, [was] imperiled." *Id.* at 359 (footnote omitted). By contrast, a more exacting equal protection analysis is required where a tax implicates another constitutional right. "Classic examples are the taxes that discriminated against . . . interstate commerce (*see Michigan-Wisconsin Pipe Line v. Calvert*, 347

[20] *Cf. Minnesota v. Cloverleaf Creamery*, 449 U.S. 456, 463 n.7 (1981) ("[i]n equal protection analysis, the Court will assume that the objectives articulated by the legislature are the actual purposes of the statute, unless an examination of the circumstances forces us to conclude that they 'could not have been a goal of the legislation' ").

U.S. 157 [(1954)]) or required licenses to engage in interstate commerce." *Lehnhausen*, 410 U.S. at 359 n.3.

Similarly, the veteran's preference at issue in *Attorney General of New York v. Soto-Lopez*, 476 U.S. 898 (1986), which implicated both the equal protection clause and the constitutionally protected right to travel, was subjected to an enhanced scrutiny.

> Whenever a state law infringes a constitutionally protected right, we undertake intensified equal protection scrutiny of that law. . . . It is well established that . . . where a law classifies in such a way as to infringe constitutionally protected fundamental rights, heightened scrutiny under the Equal Protection Clause is required.

Id. at 904, 906 n.6 (plurality opinion) (citations omitted).[21] Even when the Court uses the terminology of rational basis scrutiny, it should and does take a closer look when another right is at stake. *See Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869 (1985) (interstate commerce); *Hooper v. Bernalillo County Assessor*, 472 U.S. 612 (1985) (right to travel); *Williams v. Vermont*, 472 U.S. 14 (1985) (same).[22]

The classification in the Iowa taxing scheme—distinguishing between foreign- and domestic-source income—implicates foreign commerce, an undeniable concern of the Constitution. The right to engage in foreign commerce is surely as important as its interstate counterpart.

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[21] By contrast, because of Congress's authority to legislate in relation to foreign commerce, a distinction made by the federal government in these circumstances would not necessarily trigger this closer scrutiny.

[22] *Cf. Exxon v. Eagerton*, 462 U.S. 176 (1983). In *Eagerton*, an equal protection claim was accompanied by a preemption claim. Because the latter claim is based on the supremacy clause (U.S. Const. art. VI, cl. 2) which, unlike the commerce clause, confers no substantive rights (*see Dennis v. Higgins*, 111 S.Ct. 865, 870-72 & n.8 (1991)), there was no need for a closer look at the proffered justifications.

See Dennis v. Higgins, 111 S.Ct. 865, 870-71 (1991) (commerce clause "confer[s] a 'right' to engage in interstate trade free from restrictive regulation"); *Cruther v. Kentucky*, 141 U.S. 47, 57 (1891) ("[t]o carry on interstate commerce is not a franchise or privilege granted by the State; it is a right which every citizen of the United States is entitled to exercise under the Constitution and laws of the United States"); *Garrity v. New Jersey*, 385 U.S. 493, 500 (1967) (engaging in commerce is a "right[] of constitutional stature"). Where, as here, a statute on its face discriminates against foreign commerce, it is appropriate for a court to take a close look at the proffered justifications. *Cf. Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. at 446 (presence of foreign elements in a commerce clause claim mandates "a more extensive constitutional inquiry").

The importance of a close look in this case is reinforced by the political dynamic involved in state taxation of out-of-state businesses. Traditional judicial deference under the rational basis test reflects a presumption that legislators will not unfairly favor one class of persons over another—presumably the political process will serve as a check on such improper regulation.[23] But the political process rationale is inapplicable when legislators are not politically accountable to those subject to the legislation. Discrimination against such non-participants in the political process requires a closer look "because such discrimination is unlikely to be soon rectified by legislative means." *Cleburne v. Cleburne Living Center, Inc.*, 473 U.S. 432, 440 (1985). *See United States v. Carolene*

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[23] *See Schweiker v. Wilson*, 450 U.S. 221, 243 (1981) (Powell, J., dissenting) (judicial deference to legislative enactments "rests in part upon the principle that the political process of our majoritarian democracy responds to the wishes of the people"). *Cf. Leathers v. Medlock*, 111 S. Ct. 1438, 1443 (1991) ("[G]eneral applicability of any burdensome tax law helps to ensure that it will be met with widespread opposition. When such a law applies only to a single constituency, however, it is insulated from this political constraint").

Products Co., 304 U.S. 144, 152-53 n.4 (1938) ("legislation which restricts those political processes which can ordinarily be expected to bring about repeal of undesirable legislation [may] be subject[] to more exacting judicial scrutiny").

Because of the relative political impotence of out-of-state corporations and the importance of the right at stake, statutes that facially discriminate against foreign commerce are not entitled to a presumption that the state is not arbitrarily preferring one class over another.[24] This principle applies not only to foreign corporations, but also to multinational corporations, which are less likely to be viewed as local in character or have the political influence of wholly domestic entities. In state tax cases the Court has often recognized that "to the extent that the burden of state regulation falls on interests outside the state, it is unlikely to be alleviated by the operation of those political restraints normally exerted when interests within the state are affected." *Southern Pacific Co. v. Arizona*, 325 U.S. 761, 767-68 n.2 (1945). *See McGoldrick v. Berwind-White Coal Mining Co.*, 309 U.S. 33, 45-46 (1940). The absence of political power of out-of-state interests gives rise to the possibility—if not the probability—that a state's rationale for a discriminatory classification is pretextual. *See supra* p. 19.

Even if the Iowa taxing scheme passed "rational basis" scrutiny, therefore, it would still violate equal protection under the closer look warranted by virtue of the right at

[24] *See Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 649-50 (1981) (Blackmun, J., dissenting) (absence of political checks when legislature not politically accountable to those it taxes justifies special judicial scrutiny); *Kassel v. Consolidated Freightways Corp.*, 450 U.S. 662, 675-76 (1981) (Powell, J.) (plurality opinion) ("[l]ess deference to the legislative judgment is due" when resident-favoring exemptions weaken the natural presumption that "a State's own political processes will serve as a check against unduly burdensome regulations").

stake and the political dynamic involved here.[25] Under this closer look, Iowa's purported interest—administrative convenience that can be readily accommodated by the simple expedient of altering its tax forms—could not possibly save the State's taxing scheme from invalidation on equal protection grounds.

CONCLUSION

The decision of the Iowa supreme court should be reversed.

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[25] This sort of "close look" would apply only in a limited class of equal protection challenges to state taxing schemes. Many state taxes so challenged have no foreign (or even interstate) component.

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IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1991

KRAFT GENERAL FOODS, INC.
(formerly KRAFT, INC.),

Petitioner,

v.

IOWA DEPARTMENT OF REVENUE
AND FINANCE,

Respondent.

ON WRIT OF CERTIORARI TO
THE SUPREME COURT OF IOWA

BRIEF OF *AMICUS CURIAE* THE WASHINGTON LEGAL FOUNDATION IN SUPPORT OF PETITIONER

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INTERESTS OF THE *AMICUS CURIAE*

The Washington Legal Foundation (WLF) is a non-profit public interest law and policy center based in Washington, D.C. with over 100,000 members and supporters nationwide.[1] WLF regularly appears before federal and state courts promoting economic liberty, free enter-

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[1] By letters filed with the Clerk of the Court, the parties have consented to the filing of this brief.

prise principles, and a limited and accountable government. WLF has devoted substantial resources to litigating cases before this Court that involve impermissible attempts to usurp the unique role of the federal government and the Executive Branch in the conduct of foreign affairs or where foreign affairs considerations were involved in the resolution of the case. *See, e.g., Perpich v. U.S. Dep't of Defense*, 110 S.Ct. 2418 (1990); *Equal Employment Opportunity Comm'n v. Arabian American Oil Co.*, 111 S.Ct. 1227 (1991).

Amicus will present a broader perspective of the issues presented in this case which will assist this Court in deciding them and will focus on the Foreign Commerce Clause question before the Court.

STATEMENT OF THE CASE

In the interests of brevity, WLF is omitting any detailed statement of the facts of this case. WLF adopts by reference the statement of facts contained in the Petitioner's brief.

The essential characteristic of the Iowa tax statute which is in issue here, Iowa Code Ann. §§ 422.33, 422.35, is the adoption of the federal definition of taxable corporate income, which includes dividends received from subsidiaries incorporated abroad, and excludes dividends received from domestically incorporated subsidiaries. This facial discrimination is compounded by Iowa's refusal, in contrast to the federal tax statutes, to provide a tax credit for foreign taxes paid on account of the same foreign dividends included within the definition of corporate income.

The tax scheme in issue is essentially identical to that upheld by the Court in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) ("*Mobil*"). However, in *Mobil*, the Court was not presented with, and did not consider, the discriminatory effects of the distinction in the tax treatment of dividends depending on

whether they originate domestically or abroad.[1] In this case, in contrast, Iowa's disparate treatment of dividends, depending solely on the domicile of the corporation paying those dividends, is squarely at issue.

SUMMARY OF ARGUMENT

The Iowa income tax provisions in issue here are discriminatory on their face. They provide that dividends received from foreign subsidiaries are subject to Iowa income tax, while dividends from domestic subsidiaries are exempt from that tax. The direct effect of those provisions is that they constitute a duty imposed on the import of dividends, and the indirect effect is to discourage investment in foreign corporations. That discrimination is contrary to the limitations placed on state tax powers by both the Foreign Commerce Clause and the Import-Export Clause of the Constitution, and constitutes an impermissible intrusion into the exclusive foreign affairs jurisdiction of the federal government.

ARGUMENT

I. INTRODUCTION

There is no question that the investment activities of a company which invests in the stock of subsidiary corporations and receives dividends from those corporations constitutes commerce within the purview of the Commerce Clause of the Constitution of the United States.[2] *North American Co. v. Securities and Exchange Comm'n*, 327 U.S. 686, 693-96 (1946). As this Court long has recog-

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[1] Indeed, in *Mobil*, the Court appears to have assumed, for purposes of the decision, that Vermont's tax scheme treated all dividends as income. Mobil apparently sought to justify exclusion from income of any dividends arising from foreign operations, regardless of whether the dividends were received from a foreign or a domestic corporation. 445 U.S. at 435-36.

[2] U.S. Const., Art. I, § 8, cl. 3.

nized, the purchase and sale of securities and the transmission of dividends constitute interstate commerce when conducted across state lines. *Id.*[3]

As interstate commerce, the transmission of investment capital and the receipt of dividend income are as much the subject of regulation and protection by the federal government, and as entitled to freedom from discriminatory intrusions by state regulation, as the shipment of freight containers,[4] or the sale of cement.[5] Indeed, to the extent that constitutional analysis may require application of stricter standards when reviewing regulation of the instrumentalities of commerce,[6] as opposed to mere commodities, this Court should recognize that the transmission of capital, and the flow of dividends constituting a return on that capital, are among the central instrumentalities of the modern conduct of commerce.

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[3] "[T]he flow, through underwriting channels, of millions of dollars of securities has been of great value and benefit to North American, in addition to being of aid to the subsidiaries." 327 U.S. at 694. "The mails and the instrumentalities of interstate commerce are vital to the functioning of this system. . . . Without them, North American would be unable to exercise and maintain the influence arising from its large stock holdings, receiving notice and reports, sending proxies to stockholders' meetings, collecting dividends and interest. . . ." *Id.* (citations omitted).

[4] *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979) ("*Japan Line*").

[5] *Hale v. Bimco Trading, Inc.*, 306 U.S. 375 (1939) ("*Hale v. Bimco*").

[6] *See Mobil*, 445 U.S. at 448; *Japan Line*, 441 U.S. at 445-46. "Instrumentalities of commerce" traditionally have been defined as "tangible property used as an instrument of interstate commerce." "Indirect Encroachment on Federal Authority by the Taxing Powers of the States," 32 Harv. L. Rev. 234, 236 (1919). However, a tax on the contents of all dividends from foreign corporations is effectively a tax on commercial use of the "instrument" of dividends, when used to transmit earnings from abroad.

Such truisms bear repeating here, because the issue presented is the constitutionality of a statutory scheme which, on its face, imposes a tax burden on the receipt of dividends from foreign subsidiaries which is not imposed on the receipt of dividends from domestic subsidiaries. The net effect[7] of the Iowa tax statute in issue is to impose a special tax on the importation of dividends from abroad, and thereby discourage investment in foreign subsidiaries.

The rationale offered by the State of Iowa for adoption of this tax scheme is simplicity of operation. The State contends that adoption of the federal definition of "income" simplifies corporate paperwork while giving Iowa the advantage of federal audits and enforcement of income reporting requirements. *Kraft, Inc. v. Iowa Dep't of Revenue and Finance*, 465 N.W.2d 664, 669 (1991). That rationale, however sincere, suffers from two fatal flaws.

First, the federal taxation scheme provides a credit to the corporate parent for foreign taxes paid on the foreign subsidiary's income stream which gave rise to the dividends declared as income to the corporate parent. As a result, foreign dividends are not taxed in excess of the burden imposed by federal income taxes on the domestic subsidiary corporations, whose dividends are excluded from the definition of income to the parent corporation. Thus, even though the federal tax scheme treats domestic dividends differently from foreign dividends, it arguably does not favor one class of dividends over the other.

When Iowa failed to adopt the credit for foreign taxes, while including the dividends from foreign subsidiaries within the definition of income to the parent, Iowa imposed a discrimination against foreign investment never intended by the federal tax code or regulations. Had Iowa

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[7] This Court long has held that it will examine the effect of a tax as well as the face of the statute. *Nippert v. Richmond*, 327 U.S. 416, 431 (1946).

adopted the federal foreign tax credit in conjunction with the federal definition of income, it could argue now that it did not discriminate against investment in foreign corporate subsidiaries. However, under the facts presented in this case, Iowa cannot deny that it imposes additional taxes on corporations, on the basis of their foreign investments, not levied on the return from identical domestic investments.

The second, and more fundamental, problem with Iowa's corporate income tax, however, is Iowa's failure to recognize that it may not borrow federal tax provisions without regard to their effect on foreign commerce. The Constitution places limits upon the states which are not placed upon the federal government. The United States is permitted to discriminate against foreign commerce by the imposition of taxes applicable solely to that commerce. The states, in contrast, are forbidden from taking such measures. Thus, Iowa's tax on foreign dividends must be struck down once it is shown to discriminate against commerce with foreign corporations.

II. THE IOWA TAXING SCHEME IMPERMISSIBLY DISCRIMINATES AGAINST COMMERCE WITH FOREIGN CORPORATIONS

"[A] tax must have 'what might be called internal consistency -- that is the [tax] must be such that, if applied by every jurisdiction,' there would be no unpermissible interference with free trade." *Armco Inc. v. Hardesty*, 467 U.S. 638, 644 (1984), quoting from *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983) ("*Container Corp.*").

The Iowa tax in issue cannot pass that test. If the same tax were imposed by all of the states,[8] it would

[8] "[The] conclusion that a tax facially discriminates against interstate commerce need not be confirmed by an examination of the tax burdens imposed by other States . . . ." *Tyler Pipe Indus., Inc. v. Washington State Dep't of Revenue*, 483 U.S. 232, 247 (1987) ("*Tyler Pipe*").

create an obvious, and impermissible, interference with the right to invest in foreign subsidiaries, and to receive a return on that investment subject to the same state taxes imposed on investments in domestic corporations. *See Ashland Oil, Inc. v. Caryl*, ____ U.S. ____, 110 S. Ct. 3202, 3205 (1990).

The answer to one simple question demonstrates the fundamental failure of the Iowa tax scheme. If Iowa simply imposed an income tax on income received from investment in foreign companies, and did not impose a tax on income received from domestic investments, would that tax be constitutionally permissible? Surely, it would not, or isolationism could be imposed state by state. This Court long has held to the contrary.

The import and export of funds across national lines is a subject of regulation solely for the federal government. The question now presented is whether the State of Iowa, simply by adopting a federal statutory scheme which exercises the federal power to tax income differently depending on whether it originates domestically or abroad, can accomplish that which it may not do directly. Surely, the answer must be "no".

A. Iowa's Tax Scheme Discriminates Against Dividend Imports and Capital Exports

The importation of dividends from foreign corporations, whether in cash or in kind, cannot be placed at a substantial commercial disadvantage through discriminatory state tax treatment. *See New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 273 (1988). "[W]here simple economic protectionism is effected by state legislation, a virtually *per se* rule of invalidity has been erected." *Philadelphia v. New Jersey*, 437 U.S. 617, 624 (1978).

On its face, the Iowa income tax scheme imposes a type of duty or excise on the importation of dividends from abroad. The fact that the tax in question is essentially a duty is immediately apparent when one recalls that

a dividend can as easily be made by a distribution in kind, as by a payment in cash. *General Utils. & Operating Co. v. Helvering*, 296 U.S. 200, 202 (1935). Thus, under Iowa's tax provisions, if Petitioner, Kraft General Foods, Inc. ("Kraft"), were to receive identical dividends from a Danish subsidiary and a Wisconsin subsidiary, both in the form of a quantity of butter, one would be taxed and the other would not.[9] The imposition by the State of Iowa of a tax on the receipt of Danish butter, from which Wisconsin butter was exempt, clearly would be an improper tax on foreign trade by the state. The substitution of cash for butter does not make that same discrimination permissible.

In summary, the Iowa tax code provisions at issue here deprive investors of the right to establish or acquire foreign subsidiaries subject to the same beneficial state tax treatment afforded to investments in subsidiaries incorporated in the United States. The fundamental effect of those provisions is to discourage corporations that wish to do business in Iowa from exporting capital for investment abroad.[10]

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[9] Under Iowa's tax provisions, if Kraft either sold any butter, or used it as an ingredient in products which it sold, the receipt of a butter dividend would constitute income received in the course of the unitary business which Iowa is taxing. Kraft's sales in Iowa will be taken into account as Iowa income, however, regardless of whether or not the receipt of the dividend is added as an additional item of income. *See Moorman Mfg. Co. v. G. D. Bair*, 437 U.S. 267, 269-71, 283-85 (1978), where the Court previously discussed the operation of Iowa's provisions for allocation of a corporation's income from operation of a unitary business among the jurisdictions where that business operates.

[10] That such measures constitute export restrictions is apparent given that investment capital, as well as dividends, may be transferred in kind as an alternative to cash. *Wilgard Realty Co. v. Commissioner of Internal Revenue*, 127 F.2d 514, 515 (2d Cir.), *cert. denied*, 317 U.S. 655 (1942).

In these times of economic turmoil, such measures have a dangerous appeal. It is not hard to imagine Michigan seeking to discourage automobile manufacturers from exporting capital to acquire foreign subsidiaries for parts manufacture and assembly, or California taking similar measures with respect to the electronics industry.

B. Discrimination Against Foreign Commerce Violates the Commerce Clause

As this Court said in *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 273 (1988), "the Commerce Clause prohibits economic protectionism -- that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors."

In *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) ("*Mobil*"), this Court held that a state may tax a proportionate share of a corporation's dividend income received in the form of dividends from foreign subsidiaries and affiliates doing business abroad. However, in that case, it appears that the sole basis of the challenge was that the foreign income was not capable of "fair and equitable" apportionment between business done within and outside Vermont. 445 U.S. at 432.

Mobil's central contention was that Vermont's tax formula raised the potential for multiple taxation, because of the possibility that Mobil's domiciliary state, New York, could tax the entirety of Mobil's dividend income. 445 U.S. at 433. Mobil apparently did not raise any issue as to discrimination between the tax treatment of dividends from domestic subsidiaries and those from foreign corporations. Indeed, the Court recognized that the dividends at issue in *Mobil* came from both sources, 445 U.S. at 435, although the Court noted in passing, without comment, that the dividends from domestic subsidiaries were "subject to apportionment only in part." *Id.* at n.12. The Court, however, did not consider the constitutional implications of

state discrimination between dividends from domestic and foreign corporations.

Mobil took the position that dividends remitted as a result of foreign operations never can be subjected to state taxation. That is not the position now advanced by *amicus* WLF. Instead, the WLF asserts only that the states may not discriminate against investment in foreign companies by imposing a greater tax burden on dividends from such companies than the tax imposed on the returns from domestic investments. That issue was not addressed in *Mobil*. Therefore, *Mobil* is not controlling here.

"Foreign commerce is pre-eminently a matter of national concern. 'In international relations and with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power.' *Board of Trustees v. United States*, 289 U.S. 48, 59 (1933). Although the Constitution, Art. I, §8, cl. 3, grants Congress power to regulate commerce 'with foreign Nations' and 'among the several States' in parallel phrases, there is evidence that the Founders intended the scope of the foreign commerce power to be greater." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 448 (1979) (footnote omitted) ("*Japan Line*").

"It is a well-accepted rule that state restrictions burdening foreign commerce are subjected to a more rigorous and searching scrutiny." *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 100 (1984). *See Japan Line*, 441 U.S. at 446, where the Court stated that: "[t]he premise of appellees' argument is that the Commerce Clause analysis is identical, regardless of whether interstate or foreign commerce is involved. This premise, we have concluded, must be rejected. When construing Congress' power to 'regulate Commerce with foreign Nations,' a more extensive constitutional inquiry is required."

"Besides being fair, an apportionment formula must, under the Commerce Clause, also not result in discrimination against interstate or foreign commerce." *Container Corp.*, 463 U.S. at 170. In *Container Corp.*, the Court found that the tax in issue did not create an "*automatic* 'asymmetry' in international taxation." 463 U.S. at 195 (emphasis in original). In the present case, however, the imposition of a tax on remittances from foreign corporations, from which domestic corporations are exempt, automatically does treat foreign corporations "asymmetrically." If such an imposition is allowed to stand, the federal government is not capable of speaking with one voice on the subject of how foreign corporations will be treated in international commerce with this country.[11]

Because the tax in question is imposed solely on the import of dividends from foreign corporations, this case is fundamentally different from *Wardair Canada, Inc. v. Florida Department of Revenue*, 477 U.S. 1, 4, 9 (1986) ("*Wardair*"), where this Court upheld a Florida tax on aviation fuel sales, which applied equally to all purchasers, regardless of their destination upon flight. In the present case, the Iowa tax on the receipt of dividends applies only to those sent from abroad. Such a facial discrimination against the import of dividends is a direct violation of the limitations on state taxation imposed by the Foreign Commerce Clause.

III. THE RIGHT TO REGULATE FOREIGN COMMERCE IS RESERVED TO THE FEDERAL GOVERNMENT

"That the supremacy of the national power in the general field of foreign affairs, . . . is made clear by the Constitution was pointed out by the authors of the

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[11] *See* the dissent of Justice Powell in *Container Corp.*, 463 U.S. at 204, citing the Memorandum for the United States as *Amicus Curiae* in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, O.T. 1982, No. 81-349.

Federalist in 1787, and has since been given continuous recognition by this Court." *Hines v. Davidowitz*, 312 U.S. 52, 62 (1941) (footnote omitted).

The Framers of the Constitution committed "sole power to lay imposts and duties on imports in the Federal Government, with no concurrent state power: the Federal Government must speak with one voice when regulating commercial relations with foreign governments, and tariffs, which might affect foreign relations, could not be implemented by the States consistently with that exclusive power . . . ." *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 285 (1976) ("*Michelin Tire*").

The Import-Export Clause of the Constitution[12] prohibits the imposition of taxes by a state which are addressed to a particular category of foreign commerce. If a state decides to impose a tax on some form of commercial transaction, it must be a nondiscriminatory tax, falling equally on domestic and foreign transactions. "By definition, such a tax does not fall on imports as such because of place of origin. It cannot be used to create special protective tariffs or particular preferences for certain domestic goods, and it cannot by applied selectively to encourage or discourage any importation in a manner inconsistent with federal regulation." *Michelin Tire*, 423 U.S. at 286.

IV. WHERE CONGRESS HAS CHOSEN TO ALLOW FREE IMPORT AND EXPORT OF CAPITAL AND DIVIDENDS, THE STATES MAY NOT INTERFERE BY DISCRIMINATORY TAXATION

[12] U.S. Const., Art. I., § 10, cl. 2, which provides in pertinent part that: "No State shall, without the consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing its inspection Laws . . . ."

The WLF does not contend that the states must treat dividends received from abroad in a manner identical to their treatment at the federal level.[13] To the contrary, even where the federal government seeks to restrain foreign commerce by the imposition of duties or levies, the states may not enhance that restraint by imposing their own additional burden. *See South-Central Timber Development, Inc. v. Wunnicke*, 467 U.S. 82, 92-93 (1984), which held that a federal statute, requiring that timber cut from federal lands in Alaska be processed in Alaska before shipment out of the state, did not implicitly permit the State of Alaska to impose the same requirement with respect to timber cut from state lands.

All that is required of the states is that they treat the import of income, and the export of capital, even-handedly, imposing no greater burden based on the foreign source or destination of the funds. The State of Iowa, however, has failed to meet that requirement.

In the opinion below, the Supreme Court of Iowa rejected Kraft's challenge to the discriminatory taxation of dividends from foreign subsidiaries on the basis that discrimination is unconstitutional only if there is a showing of a particular advantage to local businesses within the taxing state. *Kraft, Inc. v. Iowa Dep't of Revenue and Finance*, 465 N.W.2d 664, 668 (Ia. 1991) ("we hold that Kraft must show, as in the case of alleged interstate discrimination, that Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme"). That, however, has never been the law in this Court. As early as 1878, this Court held that a Pennsylvania tax on goods sold at auction, which exempted goods made in America, was unconstitutional, without requiring any showing that Pennsylvania merchants thereby derived

[13] *See Mobil*, 445 U.S. at 448, apparently holding that the states need not be concerned with multiple taxation when taxing income from abroad. *See id.*, 445 U.S. at 445-46, noting that no constitutional infirmity is presented by the possibility that the same income may be taxed by more than one state.

a commercial advantage over other domestic producers. *Cook v. Pennsylvania*, 97 U.S. 566, 573 (1878). The Iowa Supreme Court erred by ignoring Kraft's discussion of the *Cook* decision in its briefs to that court.[14]

The essential error in the Iowa Supreme Court's analysis is that it assumes that a factual showing of competitive disadvantage is required, even where discrimination is apparent on the face of the statute. This Court held to the contrary in *Tyler Pipe*. As shown by that case, a simple examination of the effect of a tax, if uniformly applied by all states, can demonstrate an impermissible discrimination. 483 U.S. at 247.

In its opposition to the Petition for Certiorari, the Iowa Department of Revenue and Finance argued that the state tax on foreign dividends does not burden unitary businesses unfairly because the parent's income taxes are apportioned to tax only the portion of business done in Iowa. (Br. Opp. at 8-10). That argument, however, ignores the fact that a subsidiary's business activities in Iowa are the subject of separate Iowa income taxes paid by that subsidiary.

The weakness of the hypothetical business arrangements posited by Iowa is demonstrated by Iowa's failure to discuss the tax implications of identical scenarios, where only the state of the subsidiary's incorporation is changed. For example, consider a corporation that has two subsidiaries. Subsidiary A is a domestic corporation that does 50 percent of its business in Iowa. Subsidiary B is a foreign corporation, which does half of its business in a foreign country and does the remaining 50 percent of its business in Iowa. Both of the subsidiaries will pay Iowa income tax to the extent that they do business in Iowa.

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[14] *See also Hale v. Bimco Trading, Inc.*, 306 U.S. 375 (1939), which overturned a tax on foreign cement as discriminatory without any showing that Florida cement manufacturers thereby gained a peculiar advantage vis-a-vis other American cement manufacturers.

The parent corporation, however, will pay additional income tax on dividends received from the foreign subsidiary on account of foreign operations, in excess of whatever Iowa taxes are paid by both the foreign and the domestic subsidiaries. That additional tax, which will be imposed in proportion to the parent's Iowa business, arises solely because of the corporation's investment in a foreign corporation. The Iowa Department of Revenue has not shown, and cannot show, that the additional tax is anything other than an imposition on foreign commerce.

In the present case, if all states adopted Iowa's tax scheme, foreign investment clearly would be discouraged, and a preference shown for domestic investment. That fact compels the conclusion that Iowa's tax scheme is an impermissible intrusion into the regulation of foreign commerce, a matter reserved to the federal government.

CONCLUSION

For the foregoing reasons, the decision of the Supreme Court of Iowa should be reversed.

Respectfully submitted,

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IN THE
Supreme Court of the United States
OCTOBER TERM, 1991

KRAFT GENERAL FOODS, INC.,
Petitioner,

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE,
Respondent.

On Writ of Certiorari to the Supreme Court of Iowa

BRIEF FOR CHEVRON CORPORATION, THE COCA-COLA COMPANY, E.I. DuPONT DE NEMOURS AND CO., FORD MOTOR COMPANY, GENERAL MOTORS CORPORATION, INTERNATIONAL BUSINESS MACHINES CORPORATION, MOBIL OIL CORPORATION, NCR CORPORATION, AND W.R. GRACE & CO. AS AMICI CURIAE IN SUPPORT OF PETITIONER

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INTEREST OF THE AMICI CURIAE

The amici curiae are multinational corporations, each of whom has subsidiaries and/or affiliated corporations that do business abroad and are incorpo-

rated under the laws of foreign countries.[1] Each receives dividends from its foreign subsidiaries. Each also conducts business in, and is subject to income taxation by, Iowa and the several other states that compute a corporation's taxable income by including dividends from foreign subsidiaries while excluding dividends from U.S. subsidiaries.

Discriminatory state taxation of foreign-source dividends places amici at a material competitive disadvantage, requiring them to bear a higher effective tax rate than those of their competitors that operate exclusively within the United States. Amici accordingly have a strong interest in vindicating the anti-discrimination principle of the Foreign Commerce Clause, not only to eliminate discriminatory state tax schemes that currently penalize foreign commercial operations, but also to forestall the proliferation of such schemes that would almost certainly be triggered if this Court were to uphold the Iowa system.

Counsel for the parties have consented to the filing of this brief in letters filed with the Clerk of the Court.

SUMMARY OF ARGUMENT

The Iowa Supreme Court reached the wrong conclusion because it asked the wrong question. The test for impermissible discrimination under the Foreign Commerce Clause is not whether Iowa provides a commercial advantage to in-state commerce at the expense of out-of-state commerce, but whether it favors U.S. commerce over foreign commerce. The Interstate Commerce Clause, by its negative implications, prohibits commercial localism; the Foreign

[1] For convenience, we use "subsidiary" to refer to any wholly owned or partially owned corporation, regardless of the percentage of ownership.

Commerce Clause, in contrast, forbids commercial *nationalism*.

That fundamental prohibition is embodied not only in this Court's Foreign Commerce Clause decisions but also in the history and animating purposes of the clause itself. The Articles of Confederation had assigned expressly to the states the power to regulate foreign commerce. It became apparent, however, that a single state's discriminatory measure, though adopted to further a legitimate local objective, had the balkanizing effect of inflaming the resentment of other states and subjecting the entire nation to the risk of foreign reprisals. The states came to recognize that each could go its own way only at the expense of the others and that their collective well-being as participants in the international commercial community required a mutual surrender of their foreign commerce powers to the central government. They accordingly agreed in the new Constitution to allocate to Congress the authority to regulate commerce with foreign nations.

That cession of authority does not foreclose all state taxation of foreign commerce. Like interstate commerce, foreign commerce may be made to pay its way. Among other limitations imposed by the Foreign Commerce Clause, however, state taxation of foreign commerce, no less than state regulation of interstate commerce, must be even-handed and non-discriminatory. *See Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 444-51 (1979). To hold, as the Iowa court did, that the states may impose discriminatory burdens on foreign commerce—just as they were empowered to do under the Articles of Confederation—would nullify a core purpose of the Foreign Commerce Clause by allowing an individual state to ex-

pose the entire nation to the risk of international retaliation.

Iowa requires multinational companies to bear additional tax burdens solely because their foreign subsidiaries do business outside the United States. By disproportionately encumbering dividend income derived from foreign activities, the state's tax scheme inherently favors U.S. over foreign operations and necessarily skews the investment decisions of multinational businesses by adding discriminatory tax burdens as an additional consideration. Congress alone has the authority to enact such domestic preference legislation; it is forbidden to the states.

ARGUMENT

IOWA'S DISCRIMINATORY TAXATION OF FOREIGN-SOURCE DIVIDENDS VIOLATES THE FOREIGN COMMERCE CLAUSE

The dispositive question in this case is whether the Foreign Commerce Clause prohibits state taxation that facially discriminates against foreign commercial activity in favor of U.S. commercial activity. If it does, the Iowa tax is invalid.

It is discernible from the face of the Iowa statute that it treats foreign-source dividends less favorably than domestic-source dividends. In the words of the Iowa Supreme Court, the state "allows a deduction for dividends received from domestic corporations, but it does not allow a deduction or tax credit for those received from foreign subsidiaries." Pet. App. 2a. As this Court has recognized, the taxation of dividends effectively burdens "the underlying activity" that gives rise to the income out of which the dividends are paid. *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 440 (1980). Iowa's admittedly disadvantageous treatment of foreign-source dividends therefore operates as a discriminatory burden on the underlying foreign commercial activity itself in favor of domestic commercial activity. As a leading economist has observed, "the inclusion of foreign-source dividends in apportionable income . . . creates discrimination against the economic activities of domestic multinationals." C. McLure, Jr., *Economic Perspectives on State Taxation of Multijurisdictional Corporations* 179 (1986).

The Iowa Supreme Court did not dispute that conclusion. In its view, however, discrimination against foreign commercial activity does not offend the Foreign Commerce Clause unless it benefits exclusively *in-state* commercial activity or businesses. "[W]e hold that Kraft must show, as in the case of alleged interstate discrimination, that Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme." Pet. App. 7a. That holding is fundamentally wrong as a matter of logic, precedent, and constitutional structure.

1. In the first place, the Iowa court failed to recognize that the Interstate Commerce Clause and the Foreign Commerce Clause require different inquiries. The Interstate Commerce Clause protects the national market from state-enacted local protectionism; the focus is therefore on in-state benefits and out-of-state harms. The Foreign Commerce Clause, by contrast, protects the *global* market from state-enacted *domestic* protectionism; the proper focus is therefore on U.S. benefits and foreign harms. The Iowa court mistakenly viewed this foreign commerce case through a distorted interstate commerce lens.

But even if, as the Iowa court held, discrimination against foreign commerce were impermissible only if it

benefited in-state business, the Iowa tax would satisfy that requirement. Under the state's scheme, the disfavored class is composed of foreign commercial activities conducted by foreign subsidiary corporations; the favored class is composed of domestic commercial activities conducted by U.S. subsidiary corporations. The favored class therefore *includes* commercial activities conducted in Iowa and by Iowa corporations: the state allows a deduction for dividends received from an Iowa subsidiary or from a domestic subsidiary whose income is derived from Iowa business activity. The state's tax thus necessarily discriminates not only against foreign commerce but also in favor of Iowa commerce.

According to the Iowa court's analysis, however, even that is not enough. In its view, because the favored class embraces U.S. commerce in general rather than Iowa commerce exclusively, the discrimination is not cognizable under the Foreign Commerce Clause. Under that interpretation, the Foreign Commerce Clause would come into play only if the favored class were composed *solely* of in-state commerce or in-state businesses. In that event, however, the disfavored class would be composed of out-of-state commerce or businesses, and the measure would therefore constitute a prohibited discrimination against *interstate* commerce. If the Iowa court's approach were correct, therefore, the antidiscrimination principle of the Foreign Commerce Clause would become superfluous; it would add nothing to the prohibition of the Interstate Commerce Clause.

The Iowa Supreme Court went astray because of its misapprehension of this Court's interstate commerce decisions. This Court has said that the Commerce Clause prohibits discriminatory state taxes

that disproportionately burden interstate commerce and provide a "commercial advantage to local business." *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 268 (1984). But nothing in its decision implies that local business must be the *exclusive* beneficiary of the discrimination; it is enough that local business is *among* the beneficiaries.

That is the clear inference from *New Energy Co. v. Limbach*, 486 U.S. 269 (1988). The Court there invalidated, under the Interstate Commerce Clause, an Ohio tax credit for sales of ethanol that was available only if the ethanol was produced in Ohio or in another state providing reciprocal tax advantages to Ohio-produced ethanol. There was no showing made or required that the discrimination favored only Ohio ethanol producers; on the contrary, the statute plainly extended the discriminatory tax benefit to producers in other states with reciprocity.

That principle is fully applicable to the taxation of dividends. For example, the Interstate Commerce Clause would not permit Iowa to tax dividends received from all subsidiaries except those incorporated in states west of the Mississippi. The law would impermissibly discriminate against some out-of-state businesses in favor of Iowa businesses. It would not be saved merely because non-Iowa businesses west of the Mississippi would also benefit. By the same token, Iowa's discrimination against foreign-source dividends is not saved merely because non-Iowa domestic-source dividends also benefit from the exclusion.

Moreover, this Court's Foreign Commerce Clause decisions make clear that discrimination against foreign commerce in favor of domestic commerce is forbidden without regard to whether in-state commerce

is the exclusive beneficiary. Thus, in *Cook v. Pennsylvania*, 97 U.S. 566 (1878), the Court struck down as impermissible discrimination against foreign commerce a Pennsylvania auction tax that applied only to "foreign goods" and exempted goods of "American growth or manufacture." *Id.* at 570. It was of no consequence that the favored class embraced more than just goods of *Pennsylvania* growth or manufacture.

More recently, but to the same effect, the Court invalidated a Florida inspection fee that worked a "calculated discrimination against foreign commerce." *Hale v. Bimco Trading, Inc.*, 306 U.S. 375, 380 (1939). The statute levied an inspection fee on " 'cement imported or brought into the State of Florida from any foreign Country ' "; it assessed no such fee on U.S. made cement. *Id.* at 379. As in *Cook*, the discrimination was prohibted even though it provided a commercial advantage to all domestically produced cement, not merely Florida cement.

The lesson is clear: where a tax classification facially discriminates against foreign commerce on account of its foreign character, that is sufficient to invalidate it without regard to whether the discrimination operates to benefit all U.S. commerce or only in-state commerce.

2. That conclusion is firmly grounded in the history and purpose of the Foreign Commerce Clause. The Articles of Confederation had restricted the power of the national government and had given the states plenary authority over foreign commerce. The national government could take no action that "restrained" the states from "imposing such imposts and duties on foreigners, as their own people [were]

subjected to, or from prohibiting the exportation or importation of any species of goods or commodities whatsoever." Articles of Confederation of 1777, art. IX, § 1.

In the exercise of that power, the states enacted "a variety of commercial regulations." *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 226 (1824) (Johnson, J., concurring). Some states adopted discriminatory measures to "coerce a relaxation" of foreign "monopol[ies]" over trade and navigation, as well as "to supply their respective treasuries by imposts." 3 M. Farrand, *The Records of the Federal Convention of 1787* 547 (rev. ed. 1966) (Madison). Massachusetts, for instance, passed "prohibitory acts" for "the express 'encouragement of the agriculture and manufactures in our own country.' " *United States v. The William*, 28 F. Cas. 614, 623 (D. Mass. 1808) (No. 16,700).

The Constitution marked a dramatic reversal of roles. "One of the major defects of the Articles of Confederation, and a compelling reason for the calling of the Constitutional Convention of 1787, was the fact that the Articles essentially left the individual States free to burden commerce both among themselves and with foreign countries very much as they pleased." *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 283 (1976). The Constitution was "framed upon the theory that the peoples of the several states must sink or swim together, and that in the long run prosperity and salvation are in union and not division." *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 523 (1935).

In place of the states' "partial and separate reguations," 1 J. Elliot, *Debates on the Federal Constitu-*

tion 114 (2d ed. 1888), the Convention of 1787 sought a "vigorous national government . . . directed to a common interest." *The Federalist No. 11*, at 69 (Hamilton) (J. Cooke ed., 1961). The Framers believed that, "[i]f we are to be one nation in any respect, it clearly ought to be in respect to other nations." *The Federalist No. 42*, at 279 (Madison) (J. Cooke ed., 1961). That vision manifested itself, among other provisions, in the Foreign Commerce Clause, which reassigned from the states to Congress the power "to regulate Commerce with foreign nations." U.S. Const. art. I, § 8, cl. 3.

The Foreign Commerce Clause constituted "a voluntary surrender" of the states' "power to encourage domestic manufactures by the regulations of commerce." J. Story, *Commentaries on the Constitution* § 529 (R. Rotunda & J. Nowak eds., 1987). The Framers recognized that an individual state, acting pursuant to its own commercial interests, might adopt a discriminatory regulation that would invite foreign reprisals against the entire nation. "Whatever regulations foreign commerce should be subjected to in the ports of the Union, the general government would be held responsible for them." *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) at 228-29 (Johnson, J., concurring). Thus, foreign commercial retaliation, even if provoked by a single state's tax measure, "of necessity would be directed at American [interests] . . . in general, not just that of the taxing State, so that the Nation as a whole would suffer." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. at 450.

The Framers sought to ensure that measures bearing an inherent risk of international commercial retaliation would lie within the sole discretion of the national government, acting in the collective self-

interest of all the states, rather than within the power of each individual state acting by its own lights. "If it be otherwise, a single State can, at her pleasure, embroil us in disastrous quarrels with other nations." *Chy Lung v. Freeman*, 92 U.S. 275, 280 (1876).

That central objective illuminates the question here. Even-handed state regulation that allows foreign and domestic commerce to compete on a level playing field is not likely to provoke foreign reprisals, and does not impair the federal government's exclusive regulation of foreign commerce, because it imposes on foreign commerce no special burdens on account of its foreign character. *See Michelin Tire Corp. v. Wages*, 423 U.S. at 286. But discriminatory state regulation that treats foreign commerce less favorably than domestic commerce carries with it an intrinsic risk of international retaliation. The burden of any such reprisal would be borne not by the offending state alone, but by all the states. The Foreign Commerce Clause was intended to prevent just this sort of unilateral state action that inherently jeopardizes the commercial interests of the entire Union.

3. The constitutional defect in Iowa's taxing scheme is not merely a technical one; it has substantial practical implications that are demonstrably unfair to companies engaged in foreign commerce. The Iowa system guarantees disparate tax treatment for two corporate taxpayers that are identical in every respect except that one receives dividends from a domestic subsidiary and the second receives dividends from a foreign subsidiary. Under the Iowa scheme, the foreign-source dividends will be included in the Iowa income base, and the domestic dividends will be

excluded because of the intercorporate dividend deduction provided under federal law. That difference in treatment discriminates against foreign commerce because it directly results in a higher Iowa corporate income tax on the company with foreign subsidiary income.

A simple example illustrates the extent to which Iowa's approach discriminates against foreign commerce. If we assume two corporations whose operations are indistinguishable, except that one receives dividends from a domestic subsidiary and one from a foreign subsidiary, plain calculation shows that the disparity in Iowa tax is significant. Thus, we assume that the two parents and the two subsidiaries all have the same pre-dividend taxable income ($1 million), that the U.S. and foreign governments each impose the same 20% corporate tax rate on the respective subs, and that both subs distribute all of their post-tax income as dividends. We further assume that each parent does business equally across the United States and therefore that 2% of its income is apportioned to Iowa.

The calculation in the case of the parent with a domestic subsidiary is straightforward. The Iowa tax base will exclude the dividend received from the domestic subsidiary, so that the Iowa tax base is an apportioned share of the parent's own income, $20,000 (2% of $1 million). Assuming a 12% Iowa tax rate, that yields Iowa income tax on the parent of $2,400.

In the case of the company with a foreign subsidiary, the pre-apportionment Iowa tax base includes the parent's own income ($1 million) plus the dividend received from the subsidiary ($800,000), for a total of $1.8 million. The Iowa tax on its portion of

that income will be $4,320 (12% tax on 2% of $1.8 million), almost double the Iowa tax on the parent that operates a domestic subsidiary.[2]

4. There is no sensible justification for Iowa's discrimination. The Iowa Supreme Court sought to justify the state's approach by stressing the convenience of relying on federal regulation and using the federal tax form. But Iowa is selective in the extent to which it adopts the federal system. Iowa is content to adopt the aspect of the federal system that provides a deduction for dividends received from a domestic subsidiary, while including in income dividends received from a foreign subsidiary. But Iowa deliberately diverges from the aspect of the federal system that provides a counterbalance to that disparity—namely, the credit for foreign taxes.

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[2] This example is somewhat simplified, in part because it does not reflect any change in the apportionment formula as a result of the inclusion of foreign dividends. In Iowa, this change is quite small because Iowa, which uses a single-factor sales apportionment formula, does not include foreign sales in the denominator even when it taxes foreign-source dividends. The only adjustment that it makes is to allow the taxpayer to include in the denominator the amount of the foreign *dividends*, a much smaller number than sales. *See* Iowa Admin. Code r. 701-54.2(2). On the facts of the example, assuming that net income is 5% of sales, the Iowa adjustment to the apportionment formula would reduce the Iowa tax burden on the parent from $4,320 to $4,154, as compared to $2,400 for the parent with a domestic subsidiary.

The example also does not account for the deduction Iowa allows for 50% of the federal tax paid. *See* Iowa Code § 422.34. Because Iowa allows no analogous deduction for foreign tax paid, accounting for this complication would serve only to increase the relative disadvantage suffered by the company with foreign-source dividend income.

The Iowa court is correct in stating that there is no general prohibition against a state's adopting some, but not all, of the features of the federal system. But the Constitution does prohibit Iowa from implementing a system, either on its own or through selective adoption of the federal system, that discriminates against foreign commerce. That is precisely what Iowa has done here.

By adopting the federal intercorporate dividend deduction, Iowa has taken steps to protect corporate taxpayers with domestic subsidiaries from cumulative taxation at both corporate levels. It recognizes that a domestic subsidiary is taxed directly on its earnings, and therefore Iowa refrains from taxing those earnings a second time as income to the parent after they are distributed as dividends. Conversely, in the case of foreign-source dividends, Iowa deliberately embraces this kind of cumulative multi-level taxation. A foreign subsidiary is also taxed directly on its earnings, albeit by a foreign government, but the state ignores that fact. Without providing any credit for the foreign tax paid, Iowa proceeds to tax those earnings a second time as income to the parent after they are distributed as dividends. That approach deliberately and unfairly disadvantages companies that operate foreign subsidiaries as compared to otherwise indistinguishable companies that operate domestic subsidiaries. That sort of discrimination is barred by the Foreign Commerce Clause.

CONCLUSION

The judgment of the Supreme Court of Iowa should be reversed.

Respectfully submitted,

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QUESTION PRESENTED

Whether Iowa's unitary method of taxing corporate income facially violates the Foreign Commerce Clause because the Iowa statute uses the Internal Revenue Code's definition of taxable income to determine its tax base.

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No. 90-1918

KRAFT GENERAL FOODS, INC.,
Petitioner,

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE,
Respondent.

On Writ of Certiorari to the Supreme Court of Iowa

BRIEF OF THE NATIONAL CONFERENCE OF STATE LEGISLATURES, NATIONAL GOVERNORS' ASSOCIATION, COUNCIL OF STATE GOVERNMENTS, NATIONAL ASSOCIATION OF COUNTIES, INTERNATIONAL CITY/COUNTY MANAGEMENT ASSOCIATION, NATIONAL LEAGUE OF CITIES, AND U.S. CONFERENCE OF MAYORS AS *AMICI CURIAE* IN SUPPORT OF RESPONDENT

INTEREST OF THE *AMICI CURIAE*

Amici, organizations whose members include state, county, and municipal governments and officials throughout the United States, have a compelling interest in legal issues that affect state and local governments, including questions of state taxing authority. Reversal of the judgment below would both cripple the States' efforts to collect taxes from multinational corporations and undermine the States' at-

tempts to simplify state tax collection and payment through the use of federal standards for taxable income. *Amici* accordingly submit this brief to assist the Court in its resolution of this case.[1]

STATEMENT OF THE CASE

1. Iowa's treatment of foreign dividends is identical in all relevant respects to the Vermont taxing scheme this Court sustained against a Foreign Commerce Clause challenge in *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980).[2] Iowa, like Vermont, uses federal "taxable income" as the basis for calculating corporate "net income" subject to state income tax. *See* Iowa Code § 422.35 (defining "net income" as "taxable income . . . as properly computed for federal income tax purposes under the Internal Revenue Code").

Under the Internal Revenue Code, a corporation that owns at least 80% of the stock of another "domestic" corporation subject to federal income tax may deduct 100% of the dividends received from that corporation.[3] 26 U.S.C. § 243. Such domestic subsidiary dividends are, therefore, excluded from federal income tax. The purpose of the federal exclusion is to protect taxpayers from being taxed twice on the same activity. Congress determined that it did not

[1] The parties' letters of consent have been filed with the Clerk pursuant to Rule 37.3 of the Court.

[2] Kraft concedes that the Iowa and Vermont tax schemes affect foreign commerce "in identical fashion." *See* Pet. Br. 8-9 & n.11.

[3] A domestic corporation, in this context, is defined as one organized under the law of the United States or of any State. 26 U.S.C. § 7701(a)(4).

wish to tax a parent on dividends received from a subsidiary whose income the federal government has already taxed. *See* H.R. Rep. No. 708, 72d Cong., 1st Sess. 12 (1932); S. Rep. No. 665, 72d Cong., 1st Sess. 16 (1932).

This double taxation problem does not exist with regard to dividends paid to U.S. corporations by their foreign subsidiaries, *i.e.*, subsidiaries organized and doing business exclusively abroad, since the foreign subsidiaries' income is not subject to federal income tax. Consequently, the federal tax code does not allow a domestic corporation to deduct from taxable income the dividends that it receives from its foreign subsidiaries.[4]

As noted above, Iowa adopts the federal definition of "taxable income." As a result, Iowa's preapportionment tax base, like the federal tax system, includes dividends paid by foreign subsidiaries but not dividends paid by domestic subsidiaries.[5]

[4] The Internal Revenue Code does, however, allow a corporate taxpayer to elect either to deduct foreign income taxes it has paid on its foreign operations (26 U.S.C. § 164(a)(3)) or to take a tax credit based on the foreign income taxes it has paid and the foreign income taxes the foreign corporation has paid (26 U.S.C. §§ 901-902).

[5] This does not mean, however, that a state tax system like Iowa's does not tax domestic dividends. By taxing an apportioned share of the income out of which such dividends are paid, the Iowa system captures the value that the domestic subsidiary contributes to the unitary business. Under this system, some State will have the opportunity to apportion and tax the domestic subsidiary's income no matter where in the United States it does business; but since the income of foreign subsidiaries is not taxable, no State will ever tax more than its apportioned share of the dividends paid by the foreign subsidiary.

2. In 1981 Kraft owned over 80% of the stock of six foreign subsidiaries that were part of its unitary business and that conducted their activities outside the United States. These six subsidiaries paid Kraft dividends of approximately $10 million, all of which was earned from their foreign operations. It is undisputed that the dividends were part of Kraft's unitary business income. *See* Pet. App. 33a, 53a. The foreign countries in which the subsidiaries operated imposed withholding taxes of approximately $1.5 million on the dividends, *id.*, and the earnings from which the dividends were paid were subject to foreign income tax. *Id.* at 12a.

Kraft included these foreign subsidiary dividends in calculating its federal taxable income for 1981. In calculating its 1981 Iowa income tax, however, Kraft deducted these foreign subsidiary dividends from its federal "taxable income." Respondent Iowa Department of Revenue and Finance assessed additional taxes against Kraft for its failure to include foreign subsidiary income in its Iowa tax base, and these proceedings followed.

SUMMARY OF ARGUMENT

1. Kraft's claim that the Iowa tax statute facially violates the Foreign Commerce Clause fails at the outset because there is nothing discriminatory about Iowa's tax scheme. " 'A facial challenge to a legislative Act is, of course, the most difficult challenge to mount successfully, since the challenger must establish that no set of circumstances exists under which the Act would be valid.' " *Rust v. Sullivan*, 111 S. Ct. 1759, 1767 (1991) (citation omitted). Kraft's burden is to show that the Iowa tax, " 'on its face, [was] designed to have discriminatory economic effects.' "

Amerada Hess Corp. v. Director, Div. of Taxation, 490 U.S. 66, 75 (1989) (citation omitted). The question whether a state tax facially discriminates against foreign commerce by its treatment of the tax obligations of a unitary business obviously can be answered only by considering the overall effect of the tax on the income of the unitary business. Kraft makes no such showing. It relies instead upon conclusory generalizations and hypotheticals that misleadingly isolate Iowa's differential treatment of dividends but purposely disregard the impact of Iowa's unitary tax system on Kraft's unitary income.

2. Even if the Court concludes that it is appropriate to analyze in isolation Iowa's treatment of subsidiary dividends, the statute comports with the Foreign Commerce Clause. That Clause is not violated unless in-state business is advantaged as a result of the allegedly discriminatory state tax. A state tax law does not violate the Foreign Commerce Clause merely because it may, under some circumstances, advantage domestic business over foreign business, particularly where, as here, the State has acted in a manner consistent with national policy by expressly incorporating provisions of federal tax law. "[T]he dormant Commerce Clause, in both its interstate and foreign incarnations, only operates where the Federal Government has not spoken to ensure that the essential attributes of nationhood will not be jeopardized by States acting as independent economic actors." *Wardair Canada, Inc. v. Florida Department of Revenue*, 477 U.S. 1, 12 (1986). Its constraints on state taxing authority have no application here.

ARGUMENT

I. THE IOWA TAX STATUTE DOES NOT FACIALLY DISCRIMINATE AGAINST FOREIGN COMMERCE

We emphasize at the outset the narrowness of the determination the Court is called upon to make in this case. First, it is settled that Iowa has the power to tax its apportioned share of the dividend income that Kraft receives from its foreign subsidiaries since these dividends are a component of a unitary business that is conducted in Iowa. *See Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980). Here, as in *Mobil*, the taxpayer's "quarrel [is] with the calculation of the tax base and not with the method or accuracy of the statutory apportionment formula." *Id.* at 433. *Mobil* establishes that the dividends a foreign subsidiary pays a parent in a unitary business are no different for the purposes of determining the tax base than any other operating income. *Id.* at 440.

Second, it is likewise settled that in taxing values which a foreign subsidiary contributes to a unitary business, States may go far beyond Iowa's conservative practice of merely including foreign subsidiary dividends in state "taxable income." In *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983), this Court upheld, as consistent with the Foreign Commerce Clause, California's far more inclusive "combined" reporting tax scheme, which disregards the separate corporate form of foreign and domestic entities engaged in a unitary business, and allowed the State to include in the corporate tax base the entire net income generated abroad by the foreign subsidiaries of the unitary business. *See id.* at 168 & n.5.[6]

[6] Such a combined apportionment approach includes income of subsidiaries and affiliates in the parent's net income but disregards all intercorporate transfers, such as a parent's receipt of dividends. *See Mobil*, 445 U.S. at 441 n.15.

Third, Kraft concedes that the Iowa tax is valid under the inquiries that are unique to Foreign Commerce Clause analysis. The four-part test of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), is applicable in like fashion to both interstate and foreign commerce. *See Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 444-45 (1979) (quoting *Complete Auto*, 430 U.S. at 279). In Foreign Commerce Clause tax cases, two additional inquiries may be undertaken:

> [F]irst, whether the tax . . . creates a substantial risk of international multiple taxation, and second, whether the tax prevents the Federal Government from "speaking with one voice when regulating commercial relations with foreign governments."

Japan Line, 441 U.S. at 451.[7] The Court has already rejected a corporate taxpayer's argument that a state tax scheme just like Iowa's "prevents the Nation from speaking with a single voice in foreign commercial affairs." *Mobil*, 445 U.S. at 436. Kraft has expressly limited its challenge to the contention, based on *Complete Auto*, that the Iowa tax "discriminates" against foreign commerce. Pet. Br. 14.

[7] *Japan Line* involved "ad valorem property taxes assessed directly upon instrumentalities of foreign commerce." *Mobil*, 445 U.S. at 448. As the Court observed in *Mobil*, "the factors favoring use of the allocation method in property taxation have no immediate applicability to an income tax." *Id.* This is because income taxes affect equally all unitary businesses doing business in a State whether their owners are foreign or domestic, which is not necessarily true when taxes are imposed on tangible personal property, such as the cargo containers in *Japan Line*.

Finally, and most importantly, while there are three possible grounds for discrimination challenges to state taxes under the Commerce Clause,[8] Kraft argues only that Iowa's tax is "facially" discriminatory. Kraft does not allege that Iowa adopted the federal definition of taxable income because it intended to discriminate against foreign commerce. Nor has Kraft argued—or presented any evidence that would demonstrate—that the Iowa taxing system has the effect of unduly burdening commerce.

A. Kraft Cannot Prevail In This Facial Challenge to the Iowa Statute Because It Cannot Show That the Statute Was Designed to Have Discriminatory Effects

As the Court has recently reiterated, " '[a] facial challenge to a legislative Act is, of course, the most difficult challenge to mount successfully, since the challenger must establish that no set of circumstances exists under which the Act would be valid.' " *Rust v. Sullivan*, 111 S. Ct. 1759, 1767 (1991) (quoting *United States v. Salerno*, 481 U.S. 739, 745 (1987)). In this case Kraft must establish that the Iowa tax " 'on its face, [was] designed to have discriminatory economic effects' and thus [is] invalid under the Commerce Clause." *Amerada Hess Corp.*, 490 U.S. at 75 (quoting *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388, 406-07 (1984)).[9] *See also id.* at 76 (a tax

[8] The taxpayer may challenge a tax on the grounds that it "is facially discriminatory, has a discriminatory intent, or has the effect of unduly burdening interstate commerce." *See Amerada Hess Corp. v. Director, Div. of Taxation*, 490 U.S. 66, 75 (1989) (citation omitted).

[9] Kraft bears the burden of establishing the statute's unconstitutionality. *See Container Corp.*, 463 U.S. at 175 (internal quotations omitted); *Norton Co. v. Department of Revenue*, 340 U.S. 534, 537 (1951).

is "not facially discriminatory" if "there is no explicit discriminatory design to the tax"). In analyzing statutory discrimination alleged to violate the Commerce Clause, the "principal focus of inquiry must be the practical operation of the statute, since the validity of state laws must be judged chiefly in terms of their probable effects." *Lewis v. BT Investment Managers, Inc.*, 447 U.S. 27, 37 (1980) (collecting cases).

The exclusive reliance by Kraft and its *amici* on conclusory assertions and a few hypotheticals that totally ignore the impact of the Iowa system on taxation of unitary income is patently insufficient to meet Kraft's burden of establishing that the Iowa system on its face is designed to have discriminatory effects.[10] *Amici* Avon Products, for example, baldly asserts that "[t]he discrimination against foreign commerce effected by Iowa's tax scheme is stark." (Br. at 4). Yet beyond belaboring the obvious—that the Iowa statute differentiates, for purposes of inclusion in the tax base, between domestic subsidiary dividends and foreign subsidiary dividends—neither Kraft nor its *amici* even attempt to show that discrimination or a burdening of foreign commerce result from the Iowa scheme. In other words, Kraft's claim that the Iowa statute violates the Foreign Commerce Clause fails at the outset because Kraft has not and cannot show that

[10] "[T]he tax here falls, not on the foreign owners of an instrumentality of foreign commerce, but on a corporation domiciled and headquartered in the United States." *Container Corp.*, 463 U.S. at 188. Moreover, discrimination is unlikely because the Iowa system treats all unitary businesses alike. For this reason, the political process is available as "a safeguard against . . . abuse." *South Carolina State Highway Dep't v. Barnwell Bros.*, 303 U.S. 177, 187 (1938); *see also* Laurence Tribe, *American Constitutional Law* § 6-5 at 410 (2d ed. 1988).

the Iowa statute facially "discriminates" against foreign commerce.

B. The Iowa Statute Does Not Facially Discriminate Against Foreign Commerce Because It Does Not Facially Discriminate Against Unitary Businesses Whose Income Includes Foreign Dividends

The question whether a tax statute facially discriminates against foreign commerce of a unitary business depends upon the statute's treatment of the unitary business's tax obligation. *See Washington v. United States*, 460 U.S. 536, 545 (1983) (State's tax structure must be examined as a whole). In order to "establish a consistent and rational method of inquiry" the Court must examine "the practical effect of a challenged tax." *Mobil*, 445 U.S. at 443; *see also Maryland v. Louisiana*, 451 U.S. 725, 756 (1981). "[W]hen considering whether a tax is discriminatory, 'equality for the purposes of competition and the flow of commerce is measured in dollars and cents, not legal abstractions.'" *Armco, Inc. v. Hardesty*, 467 U.S. 638, 647 (1984) (Rehnquist, J., dissenting) (*quoting Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64, 70 (1963)).[11]

Kraft deliberately avoids this approach. Instead, it purports to demonstrate that the Iowa tax "discriminates" against foreign commerce solely because Iowa, in calculating the corporate tax base, differentiates (like the federal government) between dividends paid by a domestic corporation and dividends paid by a

[11] *See also Container Corp.*, 463 U.S. at 170-71 (under Commerce Clause, state tax might discriminate against interstate or foreign commerce if it produced double taxation of the same income "and *a resulting tax burden* higher than the taxpayer would incur if its business were limited to any one jurisdiction") (emphasis added).

foreign corporation operating outside the United States. The focal question that must be addressed in determining whether the Iowa statute discriminates against foreign commerce, however, is whether Iowa's income tax facially discriminates against unitary businesses whose income includes foreign dividends.

Iowa does not tax dividends separately, but only to the extent that they form one component of overall corporate income. It is not merely the dividends received by the parent in a unitary business, but "'the entire net income . . . generated by interstate as well as intrastate activities, [that] may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs.'" *Mobil*, 445 U.S. at 436 (quoting *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 460 (1959)). Insofar as Iowa taxes dividends from abroad received by a parent, it does so as part of the parent's unitary business income. *See Mobil*, 445 U.S. at 446. And while here, as in *Mobil*, "the State . . . include[s] [foreign] *dividends* from the subsidiaries to the parent in its calculation of the parent's apportionable taxable income," it very significantly does not include "the underlying income of the [foreign] subsidiaries themselves." *Container Corp.*, 463 U.S. at 169 n.7. Dividends obviously do not necessarily represent all of the foreign subsidiaries' earnings. "A corporation's decision as to how much of its earnings to pay out in dividends is subject to many variables. Nothing says that 100% must be passed through to the stockholders." *Mobil*, 445 U.S. at 460 n.18 (Stevens, J., dissenting). As a majority stockholder, Kraft largely can control the percentage of its subsidiaries' earnings that is paid out in dividends. *See id.*

Under the Iowa system, the earnings of foreign corporations doing business overseas become subject to tax by the United States (and by the States) only when paid as dividends to the domestic parent. Under this approach, the values that these foreign subsidiaries contribute to the unitary business are therefore never subject to apportionment unless they are paid to the parent as dividends. The underlying income of domestic subsidiaries in a unitary business, by contrast, is subject to apportionment. While the dividends that a subsidiary doing business in Iowa pays to its parent are not included in the parent's tax base, the subsidiary's earnings are themselves apportioned and subject to Iowa tax. For these reasons, from the standpoint of overall income, a unitary enterprise with an Iowa subsidiary—taxed on earnings, not dividends—is almost certain to bear a higher state tax burden than a business with a foreign subsidiary. This belies Kraft's assertion that Iowa's tax treatment of foreign dividends facially discriminates against foreign commerce.

When analyzed as a national system of state taxation, the Iowa scheme, far from discriminating against foreign commerce, actually gives much more favorable treatment to foreign than domestic subsidiaries. If we "hypothesize[] a situation where other States have passed an identical statute," *Goldberg v. Sweet*, 109 S. Ct. 582, 589 (1989), the result would be every State taxing its apportioned share of the entire operating income of domestic subsidiaries, but only taxing its apportioned share of the dividends that foreign subsidiaries actually pay—in all but the rarest cases, a smaller amount.[12]

[12] The Iowa approach is plainly far less inclusive than the California combined apportionment approach that was held in *Container Corp.* not to violate the Foreign Commerce Clause. *See* discussion *supra* at 6.

The fact that the application of a state tax is influenced in part by events outside the State "does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction.'" *Mobil*, 445 U.S. at 437 (quoting *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 445 (1940)). This is true whether the net income is generated in other States or outside the United States. *See id.* at 438. There is nothing about the nature of foreign-derived dividend income that distinguishes it for state tax purposes from general operating income. *See id.* at 437-38. "[S]o long as the intrastate and extrastate activities form[] part of a single unitary business," *id.* at 438, apportionability cannot be challenged on the theory that the source of the income may be geographically ascertained. *See id.; see also Container Corp.*, 463 U.S. at 181.

Kraft's position is "based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place." *Container Corp.*, 463 U.S. at 181. The foundation of the unitary business doctrine is that there is no single situs to which income that contributes value to a unitary business may be attributed—be it foreign dividends, a parent's own operational income, or the operational income of its domestic subsidiaries. *See Amerada Hess Corp.*, 490 U.S. at 74.

In taxing a unitary business, a State need not use geographical or transactional accounting merely be-

cause the taxpayer asserts that its income can be attributed to a specific location.

> [S]eparate accounting, while it purports to isolate portions of income received in various [locations], may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize income of the business as having a single identifiable "source" . . . .
>
> The Court has applied the same rationale to businesses operating both here and abroad.

Mobil, 445 U.S. at 438 (citation omitted). A parent corporation therefore may not treat dividends from its overseas operations as a species of value that is segregable from the earnings of its domestic operations:

> So long as dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise, those dividends are income to the parent earned in a unitary business. One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability. . . . Transforming . . . income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business. . . .

Id. at 440-41.[13]

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[13] The Court is currently reexamining whether functional integration is a prerequisite for finding the existence of a unitary business. *See Allied-Signal, Inc. v. Director, Division of Taxation*, No. 91-615 (reargument scheduled for April 22, 1992). Kraft, however, concedes that its business is unitary. Pet. App. 33a, 55a.

In short, while the Iowa tax system, like the federal system, differentiates between foreign and domestic *dividends*, it does not facially discriminate against foreign-derived *income* and does not violate the Foreign Commerce Clause. Because Iowa and other States apportion and tax the earnings of the domestic subsidiary corporations from which dividends are paid, the state tax burden of a unitary business with domestic subsidiaries will most likely be greater than the tax burden on a unitary business with foreign subsidiaries. It makes no difference if a State taxes unitary income based upon subsidiary dividends in some instances and subsidiary earnings in others. The crucial question is whether the whole of the unitary business is subjected to a higher income tax burden, and the answer to that question does not depend upon the formal labels affixed to the income. As the Solicitor General pointed out in his *amicus* brief at the petition stage (p. 9):

> While the Iowa scheme, like the federal scheme, 'facially' . . . differentiates between [domestic and foreign] . . . dividends, that does not necessarily imply that the total income stream of a foreign subsidiary is subjected by Iowa to a greater or lesser total tax burden than that of a domestic subsidiary of the same unitary enterprise.

Because Kraft cannot demonstrate that Iowa's taxing scheme on its face subjects foreign commerce to a discriminatory burden, its facial challenge to the Iowa tax must fail.

II. THE IOWA TAX STATUTE DOES NOT VIOLATE THE FOREIGN COMMERCE CLAUSE BECAUSE IT DOES NOT DISCRIMINATE IN FAVOR OF IN-STATE BUSINESS

Even if Kraft may validly focus this case solely on Iowa's tax treatment of dividends, and even if the Court concludes that the differentiation in the Iowa statute treats foreign-source income less favorably than domestic-source income, this differential treatment does not violate the Foreign Commerce Clause. The Iowa Supreme Court was correct in holding that "[i]n the commerce-clause challenge here . . . Kraft must show, as in the case of alleged interstate discrimination, that Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme." Pet. App. 7a. Invoking the Foreign Commerce Clause does not alter the meaning of "discrimination" under *Complete Auto* and subsequent cases: whether the state legislation is "designed to benefit in-state economic interests by burdening out-of-state competitors." *New Energy Co. v. Limbach*, 486 U.S. 269, 273 (1988); *see also Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 270-73 (1984).

Discrimination against interstate commerce implicates two related concerns. The Interstate Commerce Clause not only ensures Congress's power to regulate, but also affirmatively protects the citizens of one State from discriminatory actions taken by the legislature of another. "A discriminating tax imposed by a State operating to the disadvantage of . . . [another] State, is, in effect, a regulation in restraint of commerce among the States, and as such is a usurpation of the power conferred by the Constitution upon the Congress of the United States." *Walling v. Michigan*, 116 U.S. 446, 455 (1886). The Interstate Commerce

Clause "creates an area of free trade among the several States," *see Westinghouse Electric Corp. v. Tully*, 466 U.S. 388, 402 (1984), and prevents States from injuring one another through a "multiplication of preferential trade areas." *Dean Milk Co. v. City of Madison*, 340 U.S. 349, 356 (1951); *see also Hughes v. Oklahoma*, 441 U.S. 322, 325 (1979) (Interstate Commerce Clause prevents "economic Balkanization" among the States); *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327, 330 (1944) (Commerce Clause establishes "an area of free trade" among the States by forbidding them to impose barriers against each other's products and trade).

When discrimination in favor of domestic commerce over foreign commerce is alleged, the same concerns are implicated. It therefore makes no sense to argue that an additional purpose of the Foreign Commerce Clause is affirmatively to protect the trade of foreign countries and that there is a different test for "discrimination" merely because the Foreign Commerce Clause is invoked. Yet these erroneous premises are the essential underpinning of Kraft's argument that a state tax is invalid whenever it can be shown to disadvantage foreign commerce in favor of domestic commerce.

The pertinent constitutional materials amply support the settled understanding of the Interstate Commerce Clause, but offer no basis for Kraft's novel construction of the Foreign Commerce Clause. With respect to interstate commerce, Hamilton noted that "[a]n unrestrained intercourse between the States themselves will advance the trade of each by an interchange of their respective productions, not only for the supply of reciprocal wants at home, but for ex-

portation to foreign markets." *The Federalist* No. 11, at 132 (Hamilton) (Isaac Kramnick ed., 1987). On the other hand, lack of federal control of commerce between the States would lead to such "conflicts of State regulations that the citizens of each would at length come to be considered and treated by the others in no better light than that of foreigners and aliens." *Id.* No. 22, at 178 (Hamilton). The Framers sought to prevent those "regulations of trade by which particular States might endeavor to secure exclusive benefits to their own citizens." *Id.* No. 7, at 111 (Hamilton).

The purpose of the Foreign Commerce Clause was different. By 1787, the lack of federal power to regulate foreign commerce had "already operated as a bar to the formation of beneficial treaties with foreign powers." *Id.* No. 22, at 177 (Hamilton). Other countries feared dealing with a government in which "engagements on the part of the Union might at any moment be violated by its members." *Id.* No single State was powerful enough to maintain a favorable trading policy on its own. *See id.* The purpose of the Foreign Commerce Clause, therefore, was to unite and strengthen all of domestic commerce as against that of other countries. *See, e.g., id.* No. 11, at 129 (Hamilton) ("By prohibitory regulations, extending at the same time throughout the States, we may oblige foreign countries to bid against each other for the privileges of our markets.").

The two decisions upon which Kraft rests its argument, *Cook v. Pennsylvania*, 97 U.S. 566 (1878), and *Hale v. Bimco Trading, Inc.*, 306 U.S. 375 (1939), likewise fail to support it. According to Kraft, *Cook* establishes that under the Commerce

Clause no showing of in-state advantage is necessary before holding a statute unconstitutional. *See* Pet. Br. 19. But *Cook* is essentially an Import-Export Clause case. Applying that clause, *Cook* found a Pennsylvania tax "void as laying a duty on imports." 97 U.S. at 573. Since the Import-Export Clause expressly prohibits the States from "lay[ing] any Imposts or Duties on Imports or Exports," U.S. Const. art. I, § 10, a State violates that prohibition whether the duty it imposes on an import protects local industry or not.

In *Hale*, Florida's intent to discriminate to protect the Florida market—not just domestic commerce generally—was painfully apparent. The State justified its tax on foreign cement by express statutory reference to "the competitive effect of foreign cement in the Florida market," a reference which Justice Frankfurter found to be "a candid admission that the very purpose of the statute is to keep out foreign goods." 306 U.S. at 380. The Court, not surprisingly, described this explicit effort to protect the Florida market as an "assumption of national powers by a state . . . in collision with the Constitution." *Id.*

When a State is alleged to have favored domestic commerce over foreign commerce through its tax laws, the international double taxation and "speaking with one voice" tests of *Japan Line* suffice to determine whether it has violated the Foreign Commerce Clause. Leaving aside the issue of multiple taxation, which is not presented here, the state action is either consistent with federal policy, or it is not. But state legislation that favors in-state businesses over foreign business, like that of *Hale*, is more likely to interfere with congressional prerogatives. In addi-

tion, to the extent that a State favors its own commerce over that of other countries, it may also be giving an unfair advantage to its own commerce over that of other States. As *Hale* again illustrates, to the extent that Florida cement was relieved of having to compete against foreign cement in the Florida market, it gained an advantage over the products of other States not benefiting from similar home state protectionism.

The Iowa tax scheme is fundamentally different from the taxes challenged in *Cook* and *Hale*. By incorporating the federal government's treatment of foreign dividends, Iowa is manifestly not assuming national powers—it is acting consistently with national policy.[14] For it would, the Court has recently held,

> turn dormant Commerce Clause analysis entirely upside down to apply it to where the Federal Government has acted, and to apply it in such a way as to *reverse* the policy that the Federal Government has elected to follow. For the dormant Commerce Clause, in both its interstate and foreign incarnations, only operates where the Federal Government has not spoken to ensure that the essential attributes of nationhood will not be jeopardized by States acting as independent economic actors.

Wardair Canada, Inc. v. Florida Department of Revenue, 477 U.S. 1, 12 (1986).

Given the clear federal preference for Iowa's treatment of foreign dividends, Kraft's contention that the Iowa tax is somehow an "assumption of national powers" is especially unpersuasive.[15] As Justice Powell observed in *Container Corp.*, one way for a State to avoid Foreign Commerce Clause problems is to "base its apportionment calculations" of the income of a corporation receiving dividends from foreign subsidiaries on the corporation's "United States income as reported on its federal return." *Container Corp.*, 463 U.S. at 199 n.1 (Powell, J., dissenting). That is precisely what Iowa has done.[16]

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[14] Iowa and federal treatment of foreign dividends, while very similar, is not identical. Iowa does not replicate federal tax law when the corporate parent elects to take a tax credit under 26 U.S.C. §§ 901-902. But "[a]bsent some explicit directive from Congress, [the Court] cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States." *Mobil*, 445 U.S. at 448.

Moreover, Iowa's decision not to offer such a tax credit is totally consistent with federal tax policy. "[O]nce the Federal Government has allowed a credit for foreign taxes on a particular intercorporate dividend, we are not persuaded why, as a logical matter, a State would have to grant another credit of its own, since the federal credit would have already vindicated the goal of not subjecting the taxpayer to a higher tax burden that it would have to bear if its subsidiary's income were not taxed abroad." *Container Corp.*, 463 U.S. at 191 n.30.

[15] In *Container Corp.*, which upheld a state corporate tax scheme that was not patterned after federal law, the Court noted that the "Federal Government to the degree it has spoken, seems to prefer" the treatment of foreign dividends that Iowa employs here. *See Container Corp.*, 463 U.S. at 187; *see also id.* at 198 n.1, 201 (Powell, J., dissenting).

The federal government has unequivocally spoken in this case, of course, by filing a brief in support of Iowa.

[16] For the reasons set forth in the opinion of the Iowa Supreme Court, *see* Pet. App. 8a-10a, and the brief of respondent Iowa Department of Revenue and Finance, *amici* submit that the Iowa tax scheme does not violate the Equal Protection Clause.

CONCLUSION

The judgment of the Iowa Supreme Court should be affirmed.

Respectfully submitted,

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